Appendix 1

South Somerset District Council
Treasury Management Strategy Statement and Investment Strategy 2013/14

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Appendices

1. Background

1.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in Public Services (the "CIPFA TM Code") and the Prudential Code require local authorities to determine the Treasury Management Strategy Statement (TMSS) and Prudential Indicators (PIs) on an annual basis. The TMSS also includes the Annual Investment Strategy (AIS) that is a requirement of the CLG's Investment Guidance.

1.2 CIPFA has defined Treasury Management as:

"the management of the organisation's 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."

1.3 The Council adopts the key recommendations of CIPFA's Treasury Management in the Public Services: Code of Practice (the Code), as described in Section 5 of the Code.

1.4 Accordingly, the Council will create and maintain, as the cornerstones for effective treasury management:-

- A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities

- Suitable treasury management practices (TMPs), setting out the manner in which the Council will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

1.5 Full Council will receive reports on its treasury management policies, practices and activities including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close.

1.6 The Council delegates responsibility for the implementation and monitoring of its treasury management policies and practices to Audit Committee and for the execution and administration of treasury management decisions to the Assistant Director (Finance and Corporate Services) who will act in accordance with the organisation's policy statement and TMPs and CIPFA's standard of Professional Practice on Treasury Management.

1.7 The Council nominates Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

1.8 This 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.

1.9 This 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 performance measurement techniques, within the context of effective risk management.

1.10 The Council's primary objective in relation to investments remains the security of capital. The liquidity or accessibility of the Authority's investments followed by the yield earned on investments remain important but are secondary considerations.

1.11 The Council's borrowing will be affordable, sustainable and prudent and consideration will be given to the management of interest rate risk and refinancing risk. The source from which the borrowing is taken and the type of borrowing should allow the Council transparency and control over its debt.

1.12 The Council is responsible for its treasury decisions and activity. No treasury management activity is without risk. The successful identification, monitoring and control of risk is an important and integral element of its treasury management activities. The main risks to the Council's treasury activities are:

- Liquidity Risk (Adequate cash resources)
- Market or Interest Rate Risk (Fluctuations in the value of investments)
- Inflation Risk (Exposure to inflation)
- Credit and Counterparty Risk (Security of Investments)
- Refinancing Risk (Impact of debt maturing in future years)
- Legal & Regulatory Risk (Compliance with statutory and regulatory requirements)

2. Balance Sheet and Treasury Position

2.1 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR). The estimates, based on the current Revenue Budget and Capital Programmes, are set out below:

	31/03/13 Estimate £'000	31/03/14 Estimate £'000	31/03/15 Estimate £'000	31/03/16 Estimate £'000
CFR	9,381	9,447	9,332	9,234
Usable Capital Receipts	(30,399)	(29,057)	(29,077)	(29,161)
Balances & Reserves	(8,077)	(6,278)	(6,461)	(6,215)
Net Balance Sheet Position	**(29,095)**	**(25,888)**	**(26,206)**	**(26,142)**

2.2 The Council's level of physical debt and investments is linked to these components of the Balance Sheet. The current portfolio position is set out at Appendix A. Market conditions, interest rate expectations and credit risk considerations will influence the Council's strategy in determining the borrowing and investment activity against the underlying Balance Sheet position.

2.3 As the CFR represents the underlying need to borrow and revenue expenditure cannot be financed from borrowing, net physical external borrowing should not exceed the CFR other than for short term cash flow requirements.

2.4 It is permissible under the Prudential Code to borrow in advance of need up to the level of the estimated CFR over the term of the Prudential Indicators. Where this takes place the cash will form part of the invested sums until the related capital expenditure is incurred. This being the case net borrowing should not exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for the current and next two financial years other than in the short term due to cash flow requirements.

2.5 The estimate for interest payments in 2013/14 is nil and for interest receipts is £316,300

3. Outlook for Interest Rates

3.1 The Arlingclose interest rate forecast continues its theme of the last few years, that is, that interest rates will remain low for even longer. The forecast is for official UK interest rates to remain at 0.5% until 2016 given the bleak outlook for economic growth and the extension of austerity measures announced in the Chancellor's Autumn Statement. Until there is a credible resolution of the problems that stalk the Eurozone – and that resolution requires full-scale fiscal union which faces many significant political hurdles – then the UK's safe haven status and minimal prospect of increases in official interest rates will continue to combine and support the theme within the forecast.

3.2 The economic and interest rate forecast provided by the Authority's treasury management advisor is attached at Appendix C. The Authority will reappraise its strategies from time to time in response to evolving economic, political and financial events.

4. Borrowing Requirement and Strategy

4.1 Treasury management and borrowing strategies in particular continue to be influenced not only by the absolute level of borrowing rates but also the relationship between short and long term interest rates. The interest rate forecast provided in appendix C indicates that an acute difference between short and longer term interest rates is expected to continue. This difference creates a "cost of carry" for any new longer term borrowing where the proceeds are temporarily held as investments because of the difference between what is paid on the borrowing and what is earned on the investment. Whilst the cost of carry can be assumed to be a reasonably short term issue since borrowing is often for longer dated periods (anything up to 50 years) it cannot be ignored against a backdrop of uncertainty and affordability constraints in the Authority's wider financial position.

4.2 As indicated in the following table, the authority has a gross borrowing requirement of £9m in 2013/14 but has sufficient balances and reserves to avoid the need for external borrowing. By essentially lending its own surplus funds to itself the Authority is able to minimise borrowing costs and reduce overall treasury risk by reducing the level of its external investment balances.

	31/03/13 Estimate £'000	31/03/14 Estimate £'000	31/03/15 Estimate £'000	31/03/16 Estimate £'000
Capital Financing Requirement (CFR)	9,381	9,447	9,332	9,234
Less: Existing Profile of Borrowing and Other Long Term Liabilities	(268)	(334)	(219)	(121)
Cumulative Maximum External Borrowing Requirement	(9,113)	(9,113)	(9,113)	(9,113)
Capital Receipts, Balances & Reserves	(38,476)	(35,335)	(35,538)	(35,376)
Cumulative Net Borrowing Requirement (Investments/ Call on capital receipts)	**(38,476)**	**(35,335)**	**(35,538)**	**(35,376)**

4.3 The Council's strategy is to maintain maximum control over any potential long term borrowing activities as well as flexibility on its loans portfolio. Capital expenditure levels, market conditions and interest rate levels will be monitored during the year in order to minimize borrowing costs over the medium to longer term (should SSDC decide to borrow). A prudent and pragmatic approach to borrowing will be maintained to minimise borrowing costs without compromising the longer-term stability of the portfolio, consistent with the Council's Prudential Indicators.

4.4 In conjunction with advice from its treasury advisor, Arlingclose Ltd, the Council will keep under review the following borrowing options:

- Internal
- PWLB loans
- Borrowing from other local authorities
- Borrowing from institutions such as the European Investment Bank
- Commercial Banks
- Capital Markets (stock issues, commercial paper and bills)
- Structured finance
- Leasing

4.5 The Council will undertake a financial options appraisal before any borrowing is made.

4.6 For any borrowing that may be undertaken in advance of need the Council will adopt the same rigorous policies and approach to the protection of capital as it does for the investment of its surplus balances.

4.7 The cost of carry has resulted in an increased reliance upon shorter dated and variable rate borrowing. This type of borrowing injects volatility into the debt portfolio in terms of interest rate risk but is counterbalanced by its affordability and alignment of borrowing costs with investment returns. The Authority's exposure to shorter dated and variable rate borrowing is kept under regular review by reference to the difference or spread between variable rate and longer term borrowing costs. A significant narrowing in the spread (e.g. by 0.50%) will result in an immediate and formal review of the borrowing strategy to determine whether the exposure to shorter dated and variable rates is maintained or altered.

5. Investment Policy and Strategy

Annual Investment Strategy

5.1 In accordance with Investment Guidance issued by the CLG and best practice this Authority's primary objective in relation to the investment of public funds remains the security of capital. The liquidity or accessibility of the Authority's investments followed by the yields earned on investments is important but are secondary considerations.

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

5.3 Investments are categorised as 'Specified' or 'Non Specified' investments within the investment guidance issued by the CLG.

5.4 Specified investments are sterling denominated investments with a maximum maturity of one year. They also meet the "high credit quality" as determined by the Authority and are not deemed capital expenditure investments under Statute. Non specified investments are, effectively, everything else. The types of investments that will be used by the Authority and whether they are specified or non-specified are as follows:

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

5.5 Registered Providers (RPs) have been included within specified and non-specified investments for 2013/14. Investments with RPs will be analysed on an individual basis and discussed with Arlingclose prior to investing.

5.6 The Authority and its advisors, Arlingclose Ltd, select countries and financial institutions after analysis and ongoing monitoring of:

- Published credit ratings for financial institutions. The minimum credit rating for non-UK sovereigns is AA+ (or equivalent). For specified investments the minimum long term rating for counterparties is A- (or equivalent).
- Credit Default Swaps (where quoted)
- Economic fundamentals (for example Net Debt as a percentage of GDP)
- Sovereign support mechanisms
- Share Prices
- Corporate developments, news, articles, markets sentiment and momentum
- Subjective overlay

Any institution can be suspended or removed should any of the factors identified above give rise to concern. The Countries and institutions that meet the criteria for investments are included in Appendix D

5.7 Authority's Banker – The Council banks with National Westminster Bank. At the current time, it does meet the Authority's minimum credit criteria. Even if the credit rating falls below the Authority's minimum criteria, Natwest will continue to be used for short term liquidity requirements (overnight) and business continuity arrangements.

Investment Strategy

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

5.9 In order to diversify an investment portfolio largely invested in cash, investments will be placed with a range of approved investment counterparties in order to achieve a diversified portfolio of prudent counterparties, investment periods and rates of return. Maximum investment levels with each counterparty will be set to ensure prudent diversification is achieved.

5.10 Money Market Funds (MMFs) will be utilised but good treasury management practice prevails and whilst MMFs provide good diversification the Authority will also seek to diversify any exposure by utilising more than one MMF. The Authority will also restrict its exposure to MMFs with lower levels of funds under management and will not exceed 0.5% of the net asset value of the MMF. In the case of Government MMFs, the Council will ensure exposure to each Fund does not exceed 2% of the net asset value of the Fund.

5.11 The Authority has evaluated the use of Pooled Funds and determined the appropriateness of their use within the investment portfolio. Pooled funds enable the Authority to diversify the assets and the underlying risk in the investment portfolio and provide the potential for enhanced returns.

5.12 Investments in pooled funds will be undertaken with advice from Arlingclose Ltd. The Authority's current investments in Pooled Funds are listed in Appendix E; their performance and continued suitability in meeting the Authority's investment objectives are regularly monitored.

5.13 The Assistant Director (Finance and Corporate Services), under delegated powers, will undertake the most appropriate form of investments in keeping with the investment objectives, income and risk management requirements and Prudential Indicators. Decisions taken on the core investment portfolio will be reported to the Audit Committee on a quarterly basis. The Council's current level of investments is shown at Appendix A.

5.14 In any period of significant stress in the markets, the default position is for investments to be made with the Debt Management Office or UK Treasury Bills (The rates of interest from the DMADF are below equivalent money market rates, but the returns are an acceptable trade-off for the guarantee that the Council's capital is secure)

Policy on use of financial Derivatives

5.15 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 CIPFA Code requires authorities to clearly detail their policy on the use of derivatives in the annual strategy.

5.16 The Authority 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.

5.17 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.

5.18 The local authority will only use derivatives after seeking expertise, a legal opinion and ensuring officers have the appropriate training for their use.

6. Balanced Budget Requirement

6.1 The Council complies with the provisions of S32 of the Local Government Finance Act 1992 to set a balanced budget.

7. 2012/13 MRP Statement

Background:

7.1 CLG's Guidance on Minimum Revenue Provision (issued in 2010) places a duty on local authorities to make a prudent provision for debt redemption. Guidance on Minimum Revenue Provision has been issued by the Secretary of State and local authorities are required to "have regard" to such Guidance under section 21(1A) of the Local Government Act 2003.

7.2 The broad aim of the Policy is to ensure that MRP is charged over a period that is reasonably commensurate with the period over which the capital expenditure which gave rise to the debt provides benefits. In the case of borrowing supported by Revenue Support Grant, the aim is that MRP is charged over a period reasonably commensurate with the period implicit in the determination of that grant. Where a local authority's overall CFR is £nil or a negative amount there is no requirement to charge MRP.

MRP Options:

7.3 Four options for prudent MRP provision are set out in the CLG Guidance. Details of each are set out below:

Option 1 – Regulatory Method:

7.4 This method replicates the position that would have existed under the previous Regulatory environment. MRP is charged at 4% of the Authority's underlying need to borrow for capital purposes, however this option allows a historical adjustment to take place that is beneficial to some authorities. This method can only be used for supported expenditure.

Option 2 – CFR Method:

7.5 This method simplifies the calculation of MRP by basing the charge solely on the authority's CFR but excludes the technical adjustments included in Option 1. The annual MRP charge is set at 4% of the CFR at the end of the preceding financial year. This method can only be used for supported expenditure.

Option 3 – Asset Life Method:

7.6 Under this method MRP is determined by the life of the asset for which the borrowing is undertaken. This can be calculated by either of the following methods:

(a) Equal Instalments: where the principal repayment made is the same in each year,

or

(b) Annuity: where the principal repayments increase over the life of the asset. The annuity method has the advantage of linking MRP to the benefits arising from capital expenditure, where these benefits are expected to increase over the life of the asset.

7.7 MRP commences in the financial year following that in which the expenditure is incurred or, in the year following that in which the relevant asset becomes operational. This enables an MRP "holiday" to be taken in relation to assets which take more than one year to be completed before they become operational.

7.8 The estimated life of the asset will be determined in the year that MRP commences and cannot be revised. However, additional repayments can be made in any year which will reduce the level of payments in subsequent years.

7.9 If no life can be reasonably attributed to an asset, such as freehold land, the life is taken to be a maximum of 50 years. In the case of freehold land on which a building or other structure is constructed, the life of the land will be treated as equal to that of the structure, where this would exceed 50 years.

7.10 In instances where central government permits revenue expenditure to be capitalised, the Statutory Guidance sets out the number of years over which the charge to revenue must be made.

Option 4 - Depreciation Method:

7.11 The deprecation method is similar to that under Option 3 but MRP is equal to the depreciation provision required in accordance with proper accounting practices to be charged to the Income and Expenditure account

MRP Policy for 2013/14:

7.12 It is proposed that for 2013/14 the Council adopts Option 3 – Asset Life Method. Option 3 enables the calculation of MRP to be aligned with the life of the asset. If it is ever proposed to vary the terms of this MRP Statement during the year, a revised statement will be made to Council at that time.

7.13 MRP in respect of leases brought on Balance Sheet under the International Financial Reporting Standards (IFRS) based Accounting Code of Practice will match the annual principal repayment for the associated deferred liability.

8. <u>Monitoring and Reporting on Treasury Management</u>

The scrutiny of the treasury management function is carried out by the Audit Committee who then make recommendations to Full Council. The Assistant Director (Finance and Corporate Services) will report to Council/Audit Committee on treasury management activity / performance as follows:

(a) Audit Committee will be responsible for the scrutiny of treasury management activity and practices.

(b) Audit Committee will review the Treasury Management Strategy Statement, Investment Strategy, MRP Statement, and Prudential Indicators twice per year and recommend them to Council for Approval

(c) Audit Committee will monitor Treasury Management activity quarterly and annually and will approve the Treasury Management Practices on an annual basis

(d) Full Council will receive the Treasury Management Strategy Statement, Investment Strategy, MRP Statement, and Prudential Indicators prior to the start of the financial year and a mid year review against the strategy approved for the year.

(e) The Council will produce an outturn report on its treasury activity no later than 30th September after the financial year end.

9. Other Items

Training

CIPFA's revised Code requires the Assistant Director (Finance and Corporate Services) ensures that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities.

Officers tasked with treasury management responsibilities are engaged in regular financial and treasury training through attendance at selective seminars/workshops and treasury courses.

Treasury Management Advisors

The Council appointed Arlingclose as its Treasury Advisers in 2005. The provision of treasury advisory services was formally re-tendered in autumn 2009 and Arlingclose was reappointed. Among the various services received is **advice** on capital financing, borrowing and investments appropriate to the Council's individual circumstances and objectives.

The Council monitors the service through measuring:

- The timeliness of advice
- The returns from investments
- The accuracy of technical advice
- Regular market testing
- Regular internal meetings to discuss performance
- Direct access to a nominated advisor
- The quality and content of training courses

However, this doesn't divest the Council from its responsibility of its treasury decisions.

APPENDIX A

EXISTING PORTFOLIO PROJECTED FORWARD

	31/03/12 Actual £'000	31/03/13 Estimate £'000	31/03/14 Estimate £'000	31/03/15 Estimate £'000
External Borrowing: *Long-term liabilities* • *Finance Leases*	383	259	251	80
Total External Debt	**389**	**259**	**251**	**80**
Investments: *Managed in-house* • Deposits and monies on call and Money Market Funds	25,710	38,910	39,077	39,161
• Supranational bonds	13,203	0	0	0
Total Investments	**38,913**	**38,910**	**39,077**	**39,161**
(Net Borrowing Position)/ Net Investment position	**38,524**	**38,651**	**38,826**	**39,081**