APPENDIX 1

TREASURY MANAGEMENT STRATEGY – 2014/2015

Introduction

In February 2012 the Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice Fully Revised 2011 Edition (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year.

In addition, the Department for Communities and Local Government (CLG) issued revised guidance on local authority investments in March 2010 that requires the Council to approve an investment strategy before the start of each financial year.

This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Guidance.

The Authority has substantial amounts of borrowing and lending, and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

Treasury Borrowing Limits for 2014/15 to 2016/17

It is a statutory duty under s.3 of the Local Government Act 2003, and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. This amount is termed the 'Affordable Borrowing Limit'.

The Council must have regard to the Prudential Code when setting the Affordable Borrowing Limit. The Code requires an authority to ensure that its total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax levels is 'acceptable'.

The Affordable Borrowing Limit must include all planned capital investment to be financed by external borrowing and any other forms of liability, such as credit arrangements. The Affordable Borrowing Limit is to be set on a rolling basis for the forthcoming year and two successive financial years.

Treasury Management Indicators for 2014/15 – 2016/17

The Council measures and manages its exposures to treasury management risks using the following indicators. The council is asked to approve the following indicators:.

Security: average credit rating

The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the weighted average credit rating of its investment portfolio.

	2014/15
Minimum Portfolio average credit rating	A

Liquidity

The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

	2014/15
Total cash available within 3 months	£15m

Interest rate exposures

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

	2014/15	2015/16	2016/17
Upper limit on fixed interest rate exposures	£177m	£181m	£176m
Upper limit on variable interest rate exposures	£127m	£131m	£126m

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

Maturity structure of borrowing

This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Upper	Lower
Under 12 months	50%	0%
12 months and within 24 months	50%	0%
24 months and within five years	75%	0%
Five years and within 10 years	100%	0%
10 years and above	100%	0%

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal sums invested for periods longer than 364 days

The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the proportion of total principal sum invested to final maturities beyond the period end will be:

	2014/15	2015/16	2016/17
Limit on proportion of principal invested beyond year end	£50m	£50m	£50m

Borrowing limits

The Authorised limits for external debt include current commitments and proposals in the budget report for capital expenditure, plus additional headroom over and above the operational limit for unusual cash movements.

The Operational boundary for external debt is based on the same estimates as the authorised limit but without the additional headroom for unusual cash movements. This level also factors in the proposed approach to use internal cash-flow and future capital receipts as the preferred financing method for the capital programme.

	2014/15	2015/16	2016/17
Operational boundary – borrowing	£177m	£181m	£176m
Operational boundary – other long-term liabilities	£2m	£2m	£2m
Operational boundary – TOTAL	£179m	£183m	£178m
Authorised limit – borrowing	£215m	£215m	£210m
Authorised limit – other long-term liabilities	£2m	£2m	£2m
Authorised limit – TOTAL	£217m	£217m	£212m

Current Portfolio Position

The Council's treasury portfolio position at 31st December 2013 comprised:

	Principal	Ave. rate
	£m	%
External Borrowing		
Total Fixed rate funding – PWLB	50	4.79
Variable rate funding – LOBOs	20	4.50*
Other long term liabilities	Nil	N/A
TOTAL GROSS EXTERNAL DEBT	**70**	**4.71**
Investments		
Short Term Investments	**37.5**	**0.51**
Long Term Investments	Nil	N/A
TOTAL INVESTMENTS**	**37.5**	**0.51**
NET DEBT	**32.5**	

* The market loans are 'lenders options' or LOBO's. These are fixed at a relatively low rate of interest for an initial period but then revert to a higher rate of 4.5%. When the initial period is over the loans are then classed as variable, as the lender has the option to change the interest rate at 6

monthly intervals, however at this point the borrower has the option to repay the loan without penalty.
** Total Investments includes Schools balances where schools have not opted for an external bank account and cash balances related to B&NES PCT Pooled budgets and West of England Growth Points funding.

External Context & Prospects for Interest Rates (Arlingclose Ltd)

The Council has appointed Arlingclose as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following section gives their commentary on the economic context and views on the prospects for future interest rates.

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

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

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

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

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

Interest rate forecast: Arlingclose's forecast is for the Bank Rate to remain flat until late 2016, the risk to the upside (i.e. rates being higher) are weighted more heavily towards the end of the forecast horizon, as the table below shows. Gilt yields are expected to rise over the forecast period with medium- and long-dated gilts expected to rise by between 0.7% and 1.1%.

Markets are still pricing in an earlier rise in rates than warranted under Forward Guidance and the broader economic backdrop. The MPC will not raise rates until there is a sustained period of strong growth. However, upside risks weight more heavily at the end of our forecast horizon.

Arlingclose continue to project gilt yields on an upward path through the medium term. The recent climb in yields was overdone given the soft fundamental global outlook and risks surrounding the Eurozone, China and US.

Arlingclose Interest Rate Forecasts

Arlingclose central interest rate forecast – December 2013

	Bank Rate	3 month LIBID	12 month LIBID	20-year gilt yield*
Q1 2014	0.50	0.45	0.95	3.30
Q2 2014	0.50	0.50	0.95	3.35
Q3 2014	0.50	0.55	0.95	3.40
Q4 2014	0.50	0.55	1.00	3.45
H1 2015	0.50	0.55	1.10	3.55
H2 2015	0.50	0.65	1.20	3.75
H1 2016	0.50	0.80	1.30	4.05
H2 2016	0.50	0.80	1.40	4.15

* The Council can currently borrow from the PWLB at 0.80% above gilt yields

The Council has budgeted for interest rates to remain constant at 0.35% for 2014/15 & beyond.

Borrowing Strategy

The Council currently holds £70 million of long-term loans (a decrease of £50m on the previous year) as part of its strategy for funding previous years' capital expenditure, and we will continue to monitor appropriate opportunities for borrowing in line with the overall Capital Financing Requirement.

The Council's capital financing requirement (CFR, or underlying need to borrow) as at 31st March 2014 is expected to be £171 million, and is forecast to rise to £215 million by March 2015 as capital expenditure is incurred. The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

The maximum expected long-term borrowing requirement for 2014/15 is:

	£m
Not borrowed in previous years	*101*
Forecast increase in CFR	*44*
Loans maturing in 2015/16	*0*
TOTAL	***145***

The Authorities borrowing strategy will continue to recognise the implications of low short term interest rates. It is therefore likely to remain more cost effective to utilise internal resources where available and borrow short-term as the need arises.

This strategy will help to minimise borrowing costs and reduce treasury risk. The Authority will continue to regularly review the benefits of this strategy in the light of market conditions and wider changes in the economy. Arlingclose will continue to assist the Authority in this respect.

<u>Sources of borrowing</u>
The approved sources of long-term and short-term borrowing will be:

- Public Works Loan Board
- any institution approved for investments that meets the investment criteria (this includes other local authorities)
- any other bank or building society approved by the Prudential Regulation Authority to operate in the UK
- UK public and private sector pension funds (except the Avon Pension Fund)
- Public or Private Bond Placement
- Special purpose companies created to enable joint Local Authority bond issues.

The Authority has previously raised the majority of its long-term borrowing from the Public Works Loan Board, but it continues to investigate other sources of finance, such as local authority loans and bank loans, that may be available at more favourable rates.

The Authority holds £20m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. All of these

LOBOS have options during 2014/15, and although the Authority understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Authority will take the option to repay LOBO loans at no cost if it has the opportunity to do so.

Short-term and variable rate loans leave the Authority exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.

Debt Rescheduling

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. Some bank lenders may also be prepared to negotiate premature redemption terms. The Authority may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall saving or reduction in risk.

Policy on use of Financial Derivatives

Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits).

The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council 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.

Derivative counterparties

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.