APPENDIX 1

TREASURY MANAGEMENT STRATEGY – 2012/2013

Introduction

In February 2010 the Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice Fully Revised Second Edition 2009 (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year.

The Institute published a revised version of CIPFA Code in November 2011 in light of the additional financial freedoms available to local authorities in the Localism Act 2011. The Council is therefore asked to formally adopt the Treasury Management in the Public Services: Code of Practice 2011 Edition. The new Code of Practice requires some amendments to the Council's Treasury Management Policy Statement, and the Council is asked to formally adopt the new policy statement in Appendix 4.

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.

Treasury Borrowing Limits for 2012/13 to 2014/15

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 2012/13 – 2014/15

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

Treasury Management Indicators for 2012/13 – 2014/15

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.

	2012/13
Minimum Portfolio average credit rating	A+

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:

	2012/13	2013/14	2014/15
Upper limit on fixed interest rate exposures	£171m	£197m	£205m
Upper limit on variable interest rate exposures	£0m	£0m	£0m

The variable interest rate exposure limit is set at £0m to restrict the amount of variable rate debt up to the level of variable rate investments.

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	50%	0%
Five years and within 10 years	50%	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:

	2012/13	2013/14	2014/15
Limit on proportion of principal invested beyond year end	£30m	£30m	£30m

Gross and net debt
The upper limit on net debt indicator was introduced in 2011 and is intended to highlight where the Council borrowing in advance of need. Since net debt does not change when loans are borrowed and the proceeds re-invested, it is not yet clear how this indicator will work. CIPFA has not yet produced guidance on its use, and so the Council is being asked to set a deliberately high limit this year.

	2012/13	**2013/14**	**2014/15**
Upper limit on net debt *(as a proportion of gross debt)*	100%	100%	100%

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 borrowing backed by cashflow and capital receipts as the financing method for the Keynsham Town Centre Regeneration project, subject to approval.

	2012/13	**2013/14**	**2014/15**
Operational boundary – borrowing	£161m	£167m	£170m
Operational boundary – other long-term liabilities	£2m	£2m	£2m
Operational boundary – TOTAL	£163m	£169m	£172m
Authorised limit – borrowing	£171m	£197m	£205m
Authorised limit – other long-term liabilities	£2m	£2m	£2m
Authorised limit – TOTAL	£173m	£199m	£207m

Current Portfolio Position
The Council's treasury portfolio position at 31st December 2011 comprised:

	Principal	**Ave. rate**
	£m	%
Total Fixed rate funding	PWLB 100	4.45
Variable rate funding	Market 20	4.50*
Other long term liabilities	Nil	N/A
TOTAL DEBT	**120**	**4.46**
TOTAL INVESTMENTS**	**95.0**	**1.15**
NET DEBT	**25.0**	

* 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.

Prospects for Interest Rates

The Council has appointed Sterling Treasury Services 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 Context

<u>Current position</u>
The global economy appears to be teetering on the edge of another slowdown, despite early optimism for a continued recovery from the 2008 financial crisis and recession. The combination of fiscal consolidation in developed economies, monetary tightening in developing economies, the Eurozone debt crisis and, in the UK, a fall in real household income, has severely damaged business and consumer confidence. As a result, household spending and business investment have weakened, with a consequent effect on the labour market.

<u>The outlook for 2012/13</u>

The short-term global outlook is relatively pessimistic. The effect of the debt crisis is likely to cause a shallow recession in the Eurozone, reducing demand for exported goods from trading partners, thus causing slower growth elsewhere. On the brighter side, the US consumer appears to be awakening from a long slumber, possibly helping the world's largest economy avoid a similar fate to the Eurozone. After engaging in monetary tightening throughout 2011, the Chinese government could reverse its stance in response to slowing global growth to try to boost domestic demand, essential to global rebalancing. Japan appears to have recovered from the March earthquake, but unlike China, will find stimulating domestic demand to offset ebbing foreign demand more difficult. The Eurozone will remain a drag on global growth in the short run, but other large economies should allow the global economy to tread water.

Once driven by the unrelenting appetite of consumers, the UK economy is currently more reliant on global demand as the combination of fiscal consolidation, the contraction in real household incomes and the resultant negative impact on sentiment dampens domestic demand. With foreign demand, particularly from one of the country's main trading partners, slowing, the economic outlook over the near term is somewhat weaker. In this low growth environment, there is little chance of inflation remaining at current high levels. As temporary factors fall out of the twelve-month comparison and more aggressive competition becomes commonplace, the CPI rate will fall back towards target.

While GDP growth may pick up from mid- to late-2012, the deteriorating outlook is likely to prompt further monetary easing in the next few months from the Bank of England, building on the extra £75bn of asset purchases it announced in October. Bank Rate will therefore remain unchanged in the short term, but faces upside risks from mid- to late-2012 as the economy gets back on track.

Businesses and households have deleveraged since 2008. The household savings rate also remains substantially above pre-crisis levels. While this implies that households remain cautious, confidence will return as the economy starts to recover and the pressure on incomes eases. Spending is therefore likely to rise, with a beneficial impact on employment. Following substantial injections of newly created money and recovering domestic demand, monetary policy will require tightening to keep inflation in check. MPC policymakers will attempt to stay ahead of the curve to avoid the prospect of demand-led inflation boosting wages and prices.

The main downside risk is a partial breakup of the Euro-area. No matter how well managed, such an exercise would create huge uncertainty and act as a severe drag on the global and UK economy for some time.

<u>SCS and Markets Interest Rate Forecasts</u>

Sterling Consultancy Services central interest rate forecast – November 2011

	Bank Rate	1 month LIBOR	3 month LIBOR	12 month LIBOR	25 year PWLB
Current	0.50	0.73	1.01	1.79	4.06
Q1 2012	0.50	0.70	1.00	1.75	4.20
Q2 2012	0.50	0.70	1.00	1.70	4.40
Q3 2012	0.50	0.75	1.00	1.80	4.50
Q4 2012	0.75	0.85	1.05	1.90	4.50
H1 2013	1.00	1.10	1.25	2.00	4.60
H2 2013	1.50	1.60	1.75	2.50	4.70
H1 2014	2.00	2.10	2.25	3.00	4.80
H2 2014	2.50	2.60	2.75	3.50	4.90

HM Treasury Survey of Forecasts – November 2011

	Average annual Bank Rate %			
	2012	2013	2014	2015
Highest	1.1	2.6	3.0	3.7
Average	0.6	0.9	1.7	2.7
Lowest	0.5	0.5	0.9	1.4

The Council has budgeted for interest rates at 1.0% for 2012/13, 2.0% for 2013/14 & 3.0% thereafter.

Borrowing Strategy

The Council currently holds £120 million of long-term loans, 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 2012 is expected to be £142 million, and is forecast to rise to £170 million by March 2013 as capital expenditure is incurred.

The maximum expected long-term borrowing requirement for 2012/13 is:

	£m
Not borrowed in previous years	*22*
Forecast increase in CFR	*28*
Loans maturing in 2013/14	*0*
TOTAL	***50***

However, depending on the pattern of interest rates during the year, it may be more beneficial to defer borrowing until later years, and to temporarily reduce the size of the Council's investment balance instead. The capital financing budget for borrowing in 2012/13 assumes borrowing of £30 million is taken during the year.

In addition, the Council may borrow for short periods of time (normally up to two weeks) to cover unexpected cash flow shortages.

<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 on the Financial Services Authority list
- Public or Private Bond Placement
- Special purpose companies created to enable joint Local Authority bond issues.

<u>Debt instruments</u>
Loans will be arranged by one of the following debt instruments:

- fixed term loans at fixed or variable rates of interest.
- lender's option borrower's option (LOBO) loans.
- bonds

As an alternative to borrowing loans, the Council may also finance capital expenditure and incur long-term liabilities by means of:

- leases
- Private Finance Initiative

Planned Borrowing strategy for 2012/13

With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to not borrow and reduce the level of investments held instead. However, with long-term rates forecast to rise in the coming years, any such short-term savings will need to be balanced against potential longer-term costs. Officers will keep the borrowing strategy under review during the year and take advice from our external advisers with reference to movements in the differential between short term and long term interest rates.

The Council has previously raised the majority of its long-term borrowing from the Public Works Loan Board. However, the Government's decision in 2010 to raise the interest rates on new PWLB loans by around 0.85% means that other sources of finance may now be more favourable and will be kept under review.

The Public Works Loan Board 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 higher rate loans with new loans at lower interest rates where this will lead to an overall saving or reduce risk.

All rescheduling will be reported in the next available Treasury Management Monitoring report following its action with all rescheduling detailed in the annual review report.

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).

The Localism Bill 2011 includes a general power of competence that removes 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.

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.