



REPORT TO: THE MORAY COUNCIL ON 30 MARCH 2016

SUBJECT: TREASURY MANAGEMENT STRATEGY STATEMENT AND PRUDENTIAL INDICATORS

BY: CORPORATE DIRECTOR (CORPORATE SERVICES)

1. REASON FOR REPORT

- 1.1 The purpose of this report is to ask Council to approve the indicators which will be used to measure the Council's performance in Capital Investment decisions and to approve the Treasury Management Strategy and the Annual Investment Strategy for the year ahead.
- 1.2 This report is submitted to Council in terms of Section III A(3) of the Council's Scheme of Administration relating to the implementation and monitoring of the Treasury Policy Statement dealing with the management of all money and capital market transactions in connection with cash funding resources of the Council.

2. RECOMMENDATION

2.1 The Council is recommended to:

- (i) approve the Treasury Management Strategy Statement for 2016/17 contained in this report;**
- (ii) adopt the Prudential Indicators and Limits for 2016/17 in APPENDIX 1;**
- (iii) adopt the estimated Prudential Indicators and Limits for 2017/18 and 2018/19; and**
- (iv) approve the Annual Investment Strategy for 2016/17 in APPENDICES 2 and 3.**

3. BACKGROUND

- 3.1 The Local Government (Scotland) Act 2003 (the Act) and supporting regulations requires the Council to adhere to the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set prudential and treasury indicators (**APPENDIX 1**) for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable. The prudential system, underpinned by legislation and regulation provides a self-regulatory framework.
- 3.2 An important aspect of this self-regulatory framework is that it closely links with capital and asset management planning and therefore supports more effective value for money decision making on capital investment.
- 3.3 The main principles behind the prudential framework are the affordability, sustainability and prudence of borrowing decisions. The framework supports improved strategic and asset management planning.
- (a) **Affordability**
The fundamental objective of affordability is to ensure that capital plans remain within sustainable limits and in particular, to consider its impact on revenue resources and therefore taxation. Setting affordable limits for borrowing within a prudential framework is a specific requirement and helps ensure that the further objectives of sustainability and prudence are addressed.
- (b) **Sustainability**
The sustainability of the council's finances underpins the overall financial framework and is supported by the prudential code. Sustainability of finances relates to the ability of the council to sustain its current spending, tax and other policies in the long run without threatening council solvency or defaulting on of its liabilities or promised expenditure.
- (c) **Prudence**
The prudent level of borrowing is linked to ensuring that debt will only be for a capital purpose. It is also prudent that treasury management activities are carried out in accordance with good professional practice. Within the CIPFA Prudential Code, local authorities are required to adopt the CIPFA Treasury Management Code of Practice.
- 3.4 The borrowing levels within the prudential framework are linked to their implications on affordability within the revenue budgets rather than capital budgets. This means that the impact on financing and running costs is the driver of affordability rather than the level of capital budgets available. This also helps underpin the longer-term inter-generational affordability and prudence of capital investment plans. The Council's current 10 year Capital Plan does not allow for this approach.

- 3.5 Alongside the prudential framework there needs to be a comprehensive Treasury Management and Borrowing strategy. This will ensure that the principles of security and liquidity of funds is secured and that yield from investments is considered but not at the expense of security and liquidity.
- 3.6 The Indicators and Limits for 2016/17 are based on the recommended capital plan for 2016/17 also considered at this meeting.
- 3.7 The Indicators and Limits for 2017/18 and 2018/19 are based on expenditure in the ten year capital plan. These indicators are provisional until such time as the capital budgets for 2017/18 and 2018/19 are approved.
- 3.8 Indicators relating specifically to the Housing Revenue Account are based on the capital budgets for 2016/17 to 2018/19 agreed at the Special Meeting of the Moray Council on 17 February 2016 (paragraph 3 of the draft Minute refers).
- 3.9 Actual outturn figures for 2014/15 have previously been submitted to Policy and Resources Committee on 29 September 2015 (paragraph 6 of the minute refers) and these figures have also been included in the report for comparison purposes.
- 3.10 This report also updates the previously approved indicators for 2015/16 based on the estimated outturn for 2015/16.
- 3.11 The Act and subsequent Local Government Investment (Scotland) Regulations 2010, require the Council to set out its Treasury Strategy for borrowing and to prepare an Annual Investment Strategy (**APPENDICES 2 and 3**) which sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

4. TREASURY MANAGEMENT STRATEGY 2016/17

- 4.1 The proposed strategy for 2016/17 in respect of the following aspects of the treasury management function is based upon the Head of Financial Services views on interest rates, supplemented with leading market forecasts provided by the Council's treasury adviser, Arlingclose.

The strategy covers:

- prudential and treasury indicators
- the current treasury position
- prospects for interest rates & economic background
- the borrowing strategy
- policy on borrowing in advance of need
- debt rescheduling
- financial derivatives
- the investment policy

4.2 Prudential and Treasury Indicators

4.2.1 It is a statutory requirement under Section 93 of the Local Government Finance Act 1992 for the Council to produce a balanced budget. In particular, a local authority must calculate its budget requirement for each financial year to include the revenue costs incurred from capital financing decisions. This means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from:-

- increases in interest charges caused by increased borrowing to finance additional capital expenditure, and
- any increases in running costs from new capital projects

are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

4.2.2 The Local Government in Scotland Act 2003 requires the Council to determine and continuously review how much it can afford to allocate to capital expenditure. This is known as the “Affordable Capital Expenditure Limit”. The Council also has to adhere to the Prudential Code when setting this limit which ensures that the total capital investment remains within sustainable limits.

4.2.3 The key objectives of the Prudential Code are to ensure that capital investment plans of the Council are affordable, prudent and sustainable. To demonstrate these objectives the Code sets nine prudential and treasury indicators designed to support and record capital investment and treasury decision making. These are detailed in **APPENDIX 1**.

4.3 Current Treasury Position

4.3.1 The treasury position at 25 February 2016 was:-

		Actual	Rate
		£000	%
Fixed Rate Debt	PWLB	131,482	5.19
Variable Rate Debt	PWLB	-	-
	LOBO	33,400	4.68
Temporary Borrowing – Local Authorities		11,000	0.50
Total External Borrowing		175,882	4.80
Other Long Term Liabilities		32,407	n/a
Total Gross External Debt		208,289	n/a
Investments			
Short Term Investments		11,195	0.46
Net Debt		197,094	n/a

4.4 Prospects for Interest Rates and Economic Background

4.4.1 The Council has appointed Arlingclose as treasury management advisers and receive advice on investment, debt and capital finance issues. The Council recognises that responsibility for treasury management decisions rests with the Council and cannot be delegated to the adviser.

4.4.2 The advisers gather a number of City forecasts for short term (bank rate) and longer term fixed interest rates. The following table gives the Adviser's central view.

	Mar 16 %	Jun 16 %	Sept 16 %	Dec 16 %	Mar 17 %	Jun 17 %	Sept 17 %	Dec 17 %	Mar 18 %	Jun 18 %	Sept 18 %	Dec 18 %	Mar 19 %
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	0.75
3-mth LIBID	0.60	0.60	0.60	0.60	0.65	0.70	0.70	0.75	0.80	0.85	0.85	0.90	0.90
1-yr LIBID	1.00	1.00	1.05	1.10	1.10	1.15	1.20	1.25	1.30	1.35	1.35	1.40	1.40
5-yr Gilt Yield	0.93	0.95	1.00	1.05	1.10	1.20	1.30	1.40	1.50	1.55	1.60	1.65	1.70
10-yr Gilt Yield	1.50	1.65	1.70	1.75	1.80	1.90	2.00	2.05	2.10	2.15	2.20	2.25	2.30
20-yr Gilt Yield	2.30	2.35	2.40	2.50	2.60	2.63	2.65	2.68	2.70	2.73	2.75	2.78	2.80
50-yr Gilt Yield	2.35	2.40	2.50	2.55	2.65	2.68	2.70	2.73	2.75	2.78	2.80	2.83	2.85

4.4.3 The Adviser's forecast the first increase in official interest rates for Quarter 3 2018.

4.4.4 The forecast is based on the following underlying assumptions:

- The lack of inflationary pressures in 2016 and a lower growth profile than previously expected will probably push back an increase UK Bank Rate to 2018.
- Domestic demand is important for UK growth. Household spending has been and will remain a key driver of Gross Domestic Product (GDP) growth through 2016. Future consumption will continue to be supported by real wage and disposable income growth.
- Inflation is currently very low and will likely remain so over the next 12 months, on the back of low commodity prices. The falling oil price will likely mean that inflation will remain below 1% over the next 12 months.

4.5 Borrowing Strategy 2016/17

- 4.5.1 The Council's main 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.
- 4.5.2 Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer term stability of the debt portfolio. 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 either use internal resources, or to borrow short-term loans.
- 4.5.3 By adopting the above approach, the Council is able to reduce net borrowing costs and reduce overall treasury risk. The benefits of either using internal resources or borrowing short-term will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. The Council's advisers will assist with this breakeven analysis which may determine whether the Council borrows additional sums at long-term fixed rates in 2016/17 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.
- 4.5.4 In addition, the Council may borrow short term loans, normally one to six months, to cover unexpected cash flow shortages.
- 4.5.5 The approved sources of long-term and short-term borrowing are:-
- Public Works Loan Board (or successor body)
 - UK Local Authorities
 - Any Bank or Building Society authorised by the Prudential Regulation Authority to operate in the UK.
 - UK public and private sector pension funds
 - European Investment Bank
 - Capital market bond investors
 - Special purpose companies created to enable joint local authority bond issues
- 4.5.6 The Council holds £33.4 million of 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 full £33.4 million of these loans have options during 2016/17, and although the Council believes that the lenders are unlikely to exercise their option in the current low interest rate environment, there remains an element of refinancing risk.

4.6 Policy on Borrowing in Advance of Need

- 4.6.1 In accordance with best practice contained within the Scottish Investment Regulations any borrowing in advance of need will be within forward approved Capital Financing Requirement estimates and will be considered carefully to ensure that value for money can be demonstrated. As sums borrowed will be invested until expenditure is incurred, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.
- 4.6.2 Any borrowing in advance of need undertaken will be reported to members via the normal reporting mechanisms.

4.7 Debt Rescheduling

- 4.7.1 The Public Works Loan Board (PWLB) allows Councils 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 facility 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.
- 4.7.2 Other lenders, other than the PWLB, may also be prepared to negotiate premature redemption rates. This will be closely monitored with regard to the LOBO loans referred to in 4.5.6. The Council will take the option to repay LOBO loans at no cost if it is given the opportunity to do so.
- 4.7.3 The current low interest rate environment and changes in the rules regarding the premature repayment of PWLB loans has adversely affected the scope to undertake meaningful debt restructuring in recent years and there is no indication that this will change during 2016/17.

4.8 Policy on Use of Financial Derivatives

- 4.8.1 In the absence of any legal power to do so, the Council will not use standalone financial derivatives such as swaps, forwards, futures and options. Derivatives embedded into loans and investments may be used and the risks they present will be managed in accordance with the overall treasury risk management strategy.

4.9 Investment Strategy 2016/17

- 4.9.1 The Local Government Investment (Scotland) Regulations 2010 require the Council to approve an Annual Investment Strategy. This has been included as **APPENDICES 2 and 3** to this report.

4.9.2 The primary principle governing the Council's investment criteria is the security of capital and liquidity of its investments. The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

4.9.3 The Annual Investment Strategy covers:

- Creditworthiness Policy
- Investment Strategy
- Permitted Investment
- Non Treasury Investments

5. **SUMMARY OF IMPLICATIONS**

(a) Moray 2023: A Plan for the Future/ Service Plan

None specifically arising from this report.

(b) Policy and Legal

The Local Government in Scotland Act 2003 provides the powers to borrow and invest as well as providing controls and limits on these activities.

The Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Services which details best practice and complies with Government Investment (Scotland) Regulations 2010.

All Treasury Management activities are carried out in accordance with this Code and Regulations.

(c) Financial implications

All financial considerations are contained within the body of the report and the attached **APPENDICES**.

The net cost of Capital Investment and Treasury Management activities has a significant effect on the Council's overall finances.

When considering the level of future capital investment programmes, the Council should commence with the amount it can afford and sustain for financing costs in the Revenue Budget.

(d) Risk Implications

The Council is aware of the risks of passive management of the treasury portfolio and, with the support of the Council's treasury advisers, will proactively manage its investments and debt over the year.

Capital expenditure is closely monitored and Budget Managers are aware of their responsibilities to manage budget allocations.

Corporate Director of Corporate services, as Chair of the asset management Working Group has highlighted to the Council that the current 10 year capital investment programme is both unaffordable and unsustainable.

(e) Staffing Implications

None specifically arising from this report.

(f) Property

None specifically arising from this report.

(g) Equalities

None specifically arising from this report.

(h) Consultations

This report has been produced in consultation with Arlingclose.

6. CONCLUSION

6.1 The adoption of the Treasury Management Strategy Statement will ensure that the Council adopts best practice in its treasury activities.

6.2 The Annual Investment Strategy will ensure that the Council will achieve the optimum return on its investments whilst maintaining a high level of liquidity to allow flexibility and above all ensure that the Council's Investments are secure.

6.3 Establishing and subsequent monitoring of Prudential and Treasury Indicators will ensure that the Council has Capital investment plans which are affordable, prudent and sustainable.

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Background Papers:

Ref: DJB/LJC/[213-2495](#)/[213-2497](#)/[239-1357](#)/[239-1358](#)