REPORT FOR: CABINET

Date:	14 February 2013
Subject:	Treasury Management Strategy Statement, Prudential Indicators and Minimum Revenue Provision (MRP) Policy and Strategy 2013/14
Key Decision:	Yes
Responsible Officer:	Julie Alderson, Corporate Director of Resources
Portfolio Holder:	Councillor Sachin Shah, Portfolio Holder for Finance
Exempt:	No
Decision subject to Call-in:	Yes, except for the Recommendations to Council
Enclosures:	Appendix 1 - Interest Rates & the Economy Appendix 2 - Treasury Delegations Appendix 3 – Enhanced Cash Funds

Section 1 – Summary and Recommendations

This report sets out the Council's Treasury Management Strategy Statement, Prudential Indicators and Minimum Revenue Provision (MRP) Policy for 2013/14

Recommendations:
The Cabinet is requested to recommend the Council to approve:
- The Treasury Management Strategy and Prudential Indicators; and
- The Minimum Revenue Provision Policy and Strategy for 2013/14.

That Cabinet refers this report to GARM Committee for review.

Harrow COUNCIL
LONDON

Reason: (For recommendation)

To promote effective financial management and comply with the Local Authorities (Capital Finance and Accounting) Regulations 2003 and other relevant guidance.

Section 2 – Report

Introduction

1. Treasury Management is the management of the Council's investments and cash flows, its banking, money market and debt transactions together with the effective control of the risks associated with those activities.

2. The Local Government Act 2003 and supporting regulations require the Council to 'have regard to' the CIPFA Prudential Code and Treasury Management Code of Practice to set treasury and Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

3. The Act, the Codes and subsequent Investment Guidance (2010) therefore requires the Council to set out its Treasury Strategy for Borrowing and to prepare an Annual Investment Strategy that establishes the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments. CIPFA updated in 2011 both their Code of Practice and Prudential Code and the changes are fully reflected in this strategy statement.

4. The budget for each financial year includes the revenue costs that flow from capital financing decisions. Under the Code of Practice, increases in capital expenditure should 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 affordable within the projected income of the Council for the foreseeable future.

CIPFA Requirements

5. Council has adopted the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2011). The primary requirements of the Code are as follows:

   (a) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

(b) Creation and maintenance of Treasury Management Practices (“TMPs”) that set out the manner in which the Council will seek to achieve those policies and objectives.

(c) Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Half-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.

(d) Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

(e) Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body.

6. Cabinet will approve the annual treasury strategy, including borrowing and investment strategies and receive a mid-year report and annual out-turn report on treasury activities.

7. The Council has delegated responsibility for the implementation and regular monitoring of its treasury management policies and practices to the S151 officer, who acts in accordance with the organisation’s approved policy statement and TMPs. The Section 151 Officer chairs the Treasury Management Group (TMG) which consists of Deputy Section 151 Officer and the Treasury and Pensions manager, to monitor the treasury management activity and market conditions.

8. The Council has nominated GARM Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies. Further details of responsibilities are given in Appendix 2.

Treasury Management Policy Statement

9. The Council defines its treasury management activities as: “The management of the authority’s investments and 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”.

10. The 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.

11. Harrow council recognises 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 comprehensive performance measurement techniques, within the context of effective risk management.

Treasury Management Strategy for 2013/14

12. The suggested strategy for 2013/14 is based upon the treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury adviser, Sector Treasury Services. The Strategy covers:-

    - treasury limits in force that will limit the treasury risk and activities of the Council
    - Prudential and Treasury Indicators
    - the current treasury position
    - prospects for interest rates
    - the borrowing strategy
    - policy on borrowing in advance of need
    - debt rescheduling
    - the investment strategy
    - creditworthiness and counterparty policy
    - the MRP strategy

13. It is not considered necessary to produce a separate treasury strategy for HRA in light of the co-mingling of debt and investments between HRA and the General Fund. Where appropriate, details of allocations of balances and interest to HRA are contained in this report.

Treasury Limits for 2013/14 to 2015/16

14. It is a statutory duty under Section 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. The amount so determined is termed the "Affordable Borrowing Limit". In England and Wales the "Authorised Limit" represents the legislative limit specified in the Act.

15. The Council must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax and council rent levels is 'acceptable'.

16. The term an "Affordable Borrowing Limit", relates to the financing of capital plans by both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.

Prudential Indicators for 2013/14 to 2015/16

17. The Prudential Indicators are set out below.

    Table 1 shows the Council's treasury portfolio position as at 31 December 2012 and the limits for the maturity structure of fixed rate borrowing during 2012/13; and

    Tables 2 to 8 include estimates of capital expenditure; ratio of financing costs to the net revenue stream; capital financing requirement; the incremental impact of capital decisions; the authorised limits and operational boundary for external debt; upper

limit for fixed rate interest rate exposure and total sums invested for more than 364 days.

Table 1

Treasury position as at 31 December 2012		**Principal**		**Ave. rate**
		£m	£m	%
Fixed rate funding	PWLB	218.5		
	Market	131.8	350.3	**4.30**
Variable rate funding			0	
Other long term liabilities (PFI & leases)			23.4	
Total Debt			**373.7**	
Total Investments			**115.8**	**2.01**

In the table below, the maturity structure for debt for which the borrower has an option to increase the interest rate (and Harrow has the option to repay), known as Lender Option Borrower Option "LOBO" is now shown as the first date that the interest rate can be increased. Prior to 2012, the final repayment date was used to determine the maturity.

Maturity structure of fixed rate borrowing	**As at 31.12.2012**	**Upper limit**	**Lower limit**
Under 12 months	9.6%	20%	0%
12 months to 23 months	4.6%	20%	0%
24 months to under 5 years	17.2%	30%	0%
5 years to under 10 years	7.7%	40%	10%
10 years and over	60.9%	90%	30%

Exposure to debt maturing in 5 to 10 years is below the lower boundary. The most recent borrowing has been long term to take advantage of the historically low interest rates on offer and also to protect against the impact of early LOBO repayment. The position will self correct in later years.

The Capital Prudential Indicators 2011/12 to 2015/16

18. The Council's capital expenditure plans are the key driver of the treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans. The indicators present in the tables below are those suggested in best practice guidance. The Council can add or modify the indicators should this be appropriate. The values shown in the tables below for 2011-12 and 12-13 are actual and not the strategy for those years.

Capital Expenditure and Funding

Table 2	2011/12	2012/13	2013/14	2014/15	2015/16
	actual	forecast outturn	estimate	estimate	estimate
	£'000	£'000	£'000	£'000	£'000
Capital Expenditure					
Non - HRA	29,226	39,936	41,768	25,300	22,800
HRA - settlement funding	88,461				
HRA - routine	6,094	8,249	7,634	7,527	7,827
TOTAL Expenditure	**123,781**	**48,185**	**49,402**	**32,827**	**30,627**
Funding:-					
Grants	10,936	14,600	9,068	7,830	7,830
Capital Receipts	4,895	3,500	12,000	10,000	2,000
Revenue Financing	528			1,180	1,720
Major Repairs Allowance	0	8,149	7,534	6,317	6,077
Total Funding	**16,359**	**26,249**	**28,602**	**25,327**	**17,627**
Borrowing to Fund the Capital Programme	**18,961**	**21,936**	**20,800**	**7,500**	**13,000**
Borrowing - HRA settlement	**88,461**				
Total new Borrowing	**107,422**	**21,936**	**20,800**	**7,500**	**13,000**

19. The above table summarises actual and expected capital expenditure plans and the sources of funding. Sources of funding being grants, capital receipts and in respect of HRA, major repairs reserve, which is an annual charge against revenue. The funding excludes Minimum Revenue Provision (depreciation on general fund assets) which offsets the need for external borrowing.

20. The net borrowing of £21.9 million in the current year is £3.2 million below the value projected at the start of the year. Future year's expenditure plans have also been restricted. For the General Fund, borrowing for the period 2013-14 includes self funding expenditure of £12.4 million which will only be initiated if projected revenue savings exceed capital financing

21. Since 31st March 2012, the HRA debt level has been at the Government imposed debt limit and new capital expenditure is fully funded from revenue.

Ratio of Financing Costs to Net Revenue Stream

Table 3	2011/12	2012/13	2013/14	2014/15	2015/16
	actual	forecast outturn	estimate	estimate	estimate
	£'000	£'000	£'000	£'000	£'000
Ratio of financing costs to net revenue stream					
Non - HRA	12.81%	12.81%	12.51%	12.42%	13.65%
HRA	8.61%	50.74%	47.67%	46.87%	46.83%

22. This section of the indicators considers the affordability of capital expenditure by comparing net interest costs and depreciation with net revenues. A rising allocation would be a concern as it would represent an increasing demand on resources. For the General Fund the ratio moves within a narrow range of 12-14%, despite net revenues declining by 3%. The General Fund benefits in 2012-13 from the impact of taking on the additional debt to fund the HRA reform, as the new borrowing incurs a lower interest rate than current debt. Over the five years, the upward trend is due to MRP on new capital expenditure exceeding the impact of assets becoming fully depreciated. The ratios for 2012-13 to 2014-15 are lower than was predicted last year.

23. The HRA ratio has undergone dramatic change following the finance reform, jumping from 25% in 2010/11 to 53% in 2012/13 due to the additional borrowing taken on to buy the Council out of its annual subsidy payment. If the subsidy payment had been treated as a capital cost in 2010-11, the ratio for that year would have been 52%. The impact of the reforms is therefore to reduce HRA's "fixed" costs in 2012-13 and beyond. The indicator for 2011-12 is reduced by the decision not to charge MRA in the year. For the current and next two years, HRA capital expenditure is maintained at around the £8 million p.a. by utilising revenue surpluses.

Net Borrowing Requirements

Table 4	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**2015/16**
	actual	**forecast outturn**	**estimate**	**estimate**	**estimate**
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
Net borrowing requirement					
brought forward 1 April	195,898	294,681	274,232	280,908	275,274
carried forward 31 March	294,681	274,232	280,908	275,274	273,240
In year borrowing requirement	**98,783**	**-20,449**	**6,676**	**-5,634**	**-2,034**

24. The net borrowing requirement looks at the change in debt less investment balances from year to year. Net debt is forecast to fall over the 4 years as capital expenditure plans are financed from the cash generated by the depreciation of existing assets.

Capital Financing Requirement

Table 5	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**2015/16**
	actual	**forecast outturn**	**estimate**	**estimate**	**estimate**
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
Capital Financing Requirement as at 31 March					
Non – HRA	253,069	259,201	264,487	261,975	260,248
HRA	149,614	149,614	149,614	149,614	149,614
Total	**402,683**	**408,815**	**414,101**	**411,589**	**409,862**
Annual change in CFR					
Non – HRA	1,599	6,132	5,286	-2,512	-1,727
HRA	94,417	0	0	0	0
Total	**96,016**	**6,132**	**5,286**	**-2,512**	**-1,727**

25. The Capital Financing Requirement is the historic outstanding capital expenditure which has not been paid for or allocated to revenue. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure which is not funded from revenue increases the CFR. The value of finance lease assets is included.

26. General Fund CFR will broadly remain around £260 million as the capital programme (net of grants and receipts) matches MRP in the three years from 1st April 2013. For HRA, all new expenditure is funded from revenue as HRA is at its borrowing limit.

27. Total CFR estimated at 31st March 2015 is £28 million less than projected last year reflecting the cut back in capital expenditure plans. The balance of £408.8 million as at March 2013 is in excess of actual external debt of £373.6 million (including finance leases) due to internal balances used to part fund capital expenditure.

Incremental Impact of Capital Investment Decisions

Table 6	2011/12	2012/13	2013/14	2014/15	2015/16
	actual	forecast outturn	estimate	estimate	estimate
	£'000	£'000	£'000	£'000	£'000
Incremental impact of capital investment decisions	**£ p**	**£ p**	**£ p**	**£ p**	**£ p**
Increase in council tax (band D) per annum	26.74	37.32	20.59	16.45	30.86
Increase in average housing rent per week	-14.31	18.99	-2.39	-0.14	5.74

28. The incremental ratios compare the cost of debt and depreciation (MRP) linked to new capital borrowing with expected levels of council tax and rents. A high or growing ratio would suggest that council taxes or rents will have to increase to fund the capital expenditure programme. The ratio ignores the favourable impact of assets that have become fully depreciated and drop out of the depreciation charge, resulting in an overstatement of the impact.

29. For the General Fund, the ratio suggests that capital expenditure plans will have an upward pressure on Council tax. However, the earlier ratios indicate that new capital expenditure is being funded within existing debt levels. The ratio also excludes the impact of expenditure efficiency savings resulting from capital expenditure.

Changes to Gross Borrowing

Table 7	2011/12	2012/13	2013/14	2014/15	2015/16
	actual	forecast outturn	estimate	estimate	estimate
	£'000	£'000	£'000	£'000	£'000
Changes to Gross Borrowing					
Debt 1st April	261,800	350,261	350,261	340,261	334,261
Expected change in debt	88,461	0	-10,000	-6,000	0
Other long term liabilities (OLTL) 1st April	20,400	25,381	23,369	23,018	22,668
Expected change in OLTL	4,981	-2,012	-351	-350	-350
Borrowings on behalf of External Bodies	-3,168	-3,045	-2,922	-2,799	-2,676
Actual gross debt at 31st March	372,474	370,585	360,357	354,130	353,903
Capital Financing requirement 31st March	402,683	408,815	414,101	411,589	409,862
Under / (over) borrowing	30,209	38,230	53,744	57,459	55,959

30. This is a new indicator that compares the value of debt with the value of capital assets as measured by the CFR. Debt outstanding should not normally exceed CFR. The expectation is that the under borrowing will increase as cash balances are used to fund debt repayment.

Borrowing and Investment Limits

Table 8	2011/12 actual £'m	2012/13 forecast outturn £'m	2013/14 estimate £'m	2014/15 estimate £'m	2015/16 estimate £'m
Authorised Limit for external debt					
Borrowing and finance leases	375	371	414	412	410
Operational Boundary for external debt					
Borrowing	350	350	352	356	358
Other long term liabilities	25	23	23	23	22
Total	375	373	375	379	380
Upper limit for fixed interest rate exposure					
Net principal re fixed rate borrowing	350	350	352	356	358
Upper limit for variable rate exposure					
Net principal re variable rate borrowing	0	0	0	0	0
Upper limit for principal sums invested over 364 days	18	23	25	25	25

31. The final set of indicators is the debt and investment limits. The operational boundary is based on current debt plus anticipated capital receipts in each of the next three years. The expectation is that the capital programme will be funded from existing cash balances. The authorised limit is based on CFR balances.

32. It is anticipated that all borrowing will be fixed rate and that the limit for investments maturing in excess of twelve months is retained at £25 million. The HRA debt limit for each year is £149.6 million.

Interest Rate Outlook and Economic Background

33. The base rate has remained unchanged at 0.5% since March 2009. The Council has appointed Sector as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates. The following table gives the Sector central view.

Sector Bank Rate forecast for financial year ends (March)

- 2012/ 2013 0.50%
- 2013/ 2014 0.50%
- 2014/ 2015 0.75%
- 2015/ 2016 1.75%

34. Appendix 1 sets out Sector's forecasts for short term (Bank Rate) and longer fixed interest rates together with comments on the economic background. The Bank base rate is anticipated to remain unchanged until Q4, 2014 and to rise steadily thereafter. Compared with last year, the first projected increase in bank rate has been delayed by 15 months. With growth in the UK expected to remain weak for a prolonged

period as both government and individuals seek to reduce debt, the risk probably lies on the side of delayed rate increases. Although UK inflation has declined in 2012, it remains above target levels, which is likely to be tolerated until signs of stronger growth emerge.

35. The prevailing low interest rates across the yield curve have impacted on both borrowing and investment. The interest cost on additional 50 year borrowing in March 2012 was a favourable 3.48%, which compares with 4.5% for existing PWLB debt.

36. Low interest rates have detracted from income earned on cash balances. The Government's provision of low cost funds to banks and building societies has seen 1 month Libid rates fall from 0.65% at the end of 2011 to 0.37% as at December 2012, both a far cry from the 5% plus rates earned on short term deposits pre the financial crisis. The poor environment for investing is not expected to improve in 2013-14.

37. PWLB borrowing rates are expected to drift upwards as and when quantitative easing ends and markets react to the greatly expanded stock of Government debt.

38. The spread between investment returns and borrowing rates continues to entail a cost if borrowing is made in advance of needs.

Borrowing Strategy

39. The Council has a debt portfolio of £350 million, mainly long term, with an average maturity of 37 years (LOBO debt measured to final maturity). Investment balances have held up better than was expected and are valued at £116 million (31st December 2012). With the investment portfolio yielding around 2% and the average cost of debt 4.3%, there is a short term cost to carrying excessive debt. The same picture is true if investment rates are compared with new borrowing rates.

40. The excess cost of debt is expected to continue and may in fact widen a little in the next 12-24 months. In these circumstances it is not proposed to seek any new borrowing unless conditions change or the cash balance falls below a safe level.

41. Previously there has been an assumption that future capital expenditure plans will require additional borrowing in the medium term. Net capital expenditure within the General fund is being constrained and the need for additional borrowing is less likely. Following the ending of the HRA subsidy system, it was agreed that there could be the ability for part of the General Fund borrowing capacity to be used to assist in delivering additional affordable housing. The only foreseen circumstances in which new long term borrowing in the next three years might be required therefore, are either if part of the LOBO portfolio had to be refinanced early, or if made available to fund new affordable housing development, on the basis that there was no revenue impact on the General Fund. Even then, the preference would be to reduce investment balances unless the gap between investment and borrowing rates has narrowed. Lower cash balances have the additional benefit of reducing exposure both to interest rate movements and also to counterparty default.

42. It may be necessary to resort to temporary borrowing from the money markets or other local authorities to cover mismatches in timing between capital receipts and payments. This is more likely as short term cash balances fall.

43. The Council has borrowed £83.8 million under Lender Option, Borrower Option (LOBO) structures with maturities between 2050 and 2078. In exchange for an interest rate that was below that offered on long term debt by the PWLB, the lender has the option at the end of five years (and half yearly thereafter) to reset the interest rate. If the rate of interest changes, Harrow is permitted to repay the loan at no additional cost. Guidance issued in November 2011 by CIPFA requires that such borrowing be shown as maturing at the first date that the borrower can amend the interest charge. This has considerably shortened the maturity profile of the debt portfolio as shown in paragraph 16. The change in guidance does not indicate an increased likelihood of interest rates changes on LOBO debt.

44. In the current environment caution will be adopted with regard to the treasury operations. The Treasury Management Group will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to Cabinet at the first available opportunity.

45. The Council has adopted a single pooled approach for debt. Allocations to HRA are based on its capital finance requirement ("CFR"), with interest charged to HRA at the average rate on all external borrowing. With HRA's CFR expected to remain at its cap for at least the next three years, there will no change in HRA borrowing in that period. Longer term, HRA's ability to repay borrowing i.e. transfer the interest obligation to the General Fund, will depend on future capital expenditure plans.

46. HRA's maximum level of debt as measured by its capital finance requirement under the new self financing arrangements is £149.6 million

47. The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Council can ensure the security of such funds.

Debt Rescheduling

48. Opportunities to reduce the cost of debt by premature repayment or to improve the maturity profile are kept under review in discussion with the Council's treasury advisor. Early repayment of market loans is by negotiation and would only be considered if Harrow is approached by the lender. For PWLB loans, there are daily published prices for early repayment that allows analysis of the opportunities for restructuring. There is currently a spread of 0.8% (based on the PWLB "certainty rate"), which has generally made restructuring uneconomic. However, with longer term borrowing rates higher than short term rates and investment returns, there are potential savings from either repaying long term debt from cash balances or switching to shorter term debt. To date such opportunities have been declined as the overall debt level was expected to be maintained and any repaid debt would have to be replaced at a longer term adverse cost. With capital expenditure plans being constrained, the level of required debt will be monitored and if deemed excessive, early redemption will be considered.

49. Should any of the LOBO loans with interest rate reset dates in 2012-13 (£33.8 million) require refinancing, the most likely source will be a combination of internal

cash and external borrowing to protect the budget. The ratio will depend on the relative cost of the existing and replacement debt.

50. All rescheduling will be reported to Cabinet at the earliest meeting following the exercise.

Annual Investment Strategy

Investment Policy

51. The Council approves a Treasury Management Strategy on an annual basis and has adopted the 'CIPFA code of Practice for Treasury Management in the Public Services'.

52. The Council will have regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities are: -

    (a) The security of capital, and
    (b) The liquidity of its investments.

53. The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

54. The Council does not borrow monies purely to invest or on-lend.

Creditworthiness and Counterparty Policy

55. Managing the investment portfolio in recent years has faced two significant headwinds. Firstly the decline in yields available and secondly the downgrades to the credit ratings of banks. The impact has been a more concentrated portfolio and a decline in income.

56. As an example of the continued drop in yields, the best one year rate currently available is 1.1%, considerably lower than the 3% received last April. The yield enhancement for investing over 2 and 3 years has almost vanished. At the short end, rates on the one month notice account have fallen from 0.82% to 0.45%. Despite these changes, the average rate earned in 2012-13 is projected to be 1.8% compared with 1.65% last year.

57. The maximum maturity for counterparties was generally 5 years pre 2012. The current strategy permitted a maximum maturity of 3 years for Lloyds and RBS and only 3 months for all other banks. The maximum maturities are in line with guidance from Sector, with the extended maturities for the two part nationalised banks reflecting the increased security of their ownership by the UK Government. The combination of the greater security and the higher rates on offer from Lloyds and RBS enabled Council to approve 30% limits for each of these banks, compared with 20% for the other main UK banks. The limit for each of Lloyds and RBS was increased to 50% of total deposits in October 2012.

58. The investment portfolio has become concentrated with the two part-nationalised banks representing 93% of the portfolio at 31st December 2012. Diversification has been sacrificed in recognition of the increased security from part government ownership and also to take advantage of the higher yields on offer.

59. Looking forward, there are a number of factors that support a more diversified portfolio and a move towards normalisation of the maximum maturities for the UK banks. Firstly, the UK and world economies have stabilised as reflected in the recent strength of the stock market. Bank share prices and the cost of insuring against default, if not their credit ratings, have benefited from the more upbeat mood. For example, the share prices of RBS and Lloyds have doubled in the year and the cost of default insurance (CDS spreads) fallen by 60%. Secondly, the Government aims to sell its stake in Lloyds and RBS, which will remove the additional security offered by Government ownership. Finally, the rates offered by these two banks have moved closer to the rates of the other UK banks, eroding the additional return previously offered. Sector have recognised that the more negative scenarios for the banks are less likely and have removed the temporary three month maximum maturity for most banks that they recommended in 2011. For the better rated banks, recommended maximum maturities have increased to 12 months and occasionally more. Despite these favourable developments only limited change is proposed at present as wider change would not generate additional income opportunities.

60. Two amendments are proposed to the counterparty policy. Firstly, for banks that meet the more demanding credit quality of specified investments that the maximum maturity return to 12 months. Secondly, that the use of money market funds is extended to enhanced cash funds. These funds share many of the characteristics of money market funds but by allowing longer maturities are able to earn higher returns. Appendix 3 provides further details on these funds. This proposal was discussed with GARMC on 23rd January, who supported the use of enhanced cash funds and requested updates on the timing of the implementation.

61. The Investment instruments identified for use in the financial year are listed below under the ‘Specified’ and ‘Non-Specified’ Investments categories. Specified investments are considered low risk and relate to funds invested for up to one year. Non-Specified investments normally offer the prospect of higher returns but carry a higher risk and may have a maturity beyond one year. All investments and borrowing are sterling denominated.

Specified Investments

62. All such investments will have maturities up to maximum of 1 year, meeting the minimum rating criteria where applicable. The instruments and credit criteria to be used are set out in the table below.

Instrument	Minimum Credit Criteria	Use
Debt Management Agency Deposit Facility	Government backed	In-house
Term deposits – other LAs	Local Authority issue	In-house
Term deposits – banks and building societies	AA- Long Term F1+Short-term 2 Support AA- Viability AAA Sovereign	In-house
Money Market Funds	AAA	In-house

Non-Specified Investments

	Minimum Credit Criteria	Use	Max % of total investments	Max. maturity period
Term deposits – banks and building societies	A Long Term F1 Short-term 1 Support A Viability UK or AAA Sovereign	In-house	50%	3 months
Callable Deposits	F1 Short term A Long Term 1 Support	In-house	20%	3 months
UK nationalised Banks [RBS & Lloyds / HBOS]	F1 Short-term 1 Support	In-house	50% for each of the two Groups	36 months
Enhanced Cash Funds	AAA	In-house	25% (maximum £10 million per fund)	Minimum monthly redemption

63. Unless specified above, individual bank & building society counterparty limits that are consistent with the above limits are approved by the Section 151 Officer in accordance with the Council's Treasury Management Practices.

64. All credit ratings will be monitored in house with the help of Sector who alert the Council to changes in credit ratings through its creditworthiness service.

65. If a downgrade results in the counterparty no longer meeting the Council's minimum criteria, its further use as an investment will be withdrawn immediately.

Investment Strategy

66. The Council's funds are mainly cash flow derived and include the General Fund, West London Waste Authority and Housing Revenue Account balances. Balances are also held to support capital expenditure. From 1st April 2011, pension fund cash balances have been held separately from those of the Council. A separate investment strategy has not been developed for the pension fund. All its cash (circa £22 million as at December 2012) is held on overnight call account with RBS.

67. The counterparty policy recognises the greater uncertainty within the financial sector by limiting deposits to three months for those banks that are not UK government owned or the higher rated specified investments. Selective deposits with maturities of over three months will be made with Lloyds / HBOS and RBS to obtain the benefit of the higher rates on offer provided that prudent liquidity is maintained. In no event will more than £25 million be invested for maturities of more than 12 months. Enhanced cash funds will enable rates similar to 1-2 two year deposits to be obtained without sacrificing credit quality or liquidity.

68. Due to the low interest rates environment and uncertainties around Government funding for banks, setting expected income levels for 2013-14 and beyond is imprecise. Investment income (net of allocations) has been budgeted at £1,565,000 for 2013/14 (2012/13 £1,511,000). The income forecast assumes that the proposed changes in counterparty policy will be agreed and also factors in a revised basis of allocating interest income to third party balances.

Minimum Revenue Provision

What is a Minimum Revenue Provision?

69. Capital expenditure is generally defined as expenditure on assets that have a life expectancy of more than one year e.g. buildings, vehicles, machinery etc. The accounting approach is to spread the cost over the period during which such assets are used to provide services to the local community. The mechanism for spreading these costs is through an annual Minimum Revenue Provision, which was previously determined under Regulation but, from April 2009, is now determined under Guidance. The Minimum Revenue Provision (MRP) is the means by which capital expenditure which is financed by borrowing or credit arrangements is funded by council tax and rent payers. The purpose of MRP is to enable the Council to make prudent provision to redeem its debt liability over a period that is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits.

Minimum Revenue Provision Policy Statement 2013/14

70. The Council will assess their MRP for 2013/14 in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

71. CLG guidance effective from March 2010 requires the full Council to approve an MRP Statement in advance of each year. A variety of options are provided to

councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement.

I. For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the MRP policy will be the existing practice (option 1) and MRP will follow the existing practice outlined in former CLG regulations. This option provides for an approximate 4% reduction in the borrowing need (CFR) each year; and

II. From 1 April 2008 for all unsupported borrowing (including PFI and finance leases), the MRP policy will be Asset life method (option 3) and MRP will be based on the estimated life of the assets in accordance with the proposed regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction).

III. A voluntary MRP may be made from either revenue or voluntarily set aside capital receipts and will be applied to the remaining life of the assets.

72. Estimated life periods will be determined under delegated powers and will generally follow those set out in the guidance. However, the Council reserves the right to determine useful life periods and prudent MRP in exceptional circumstances where the recommendations of the guidance would not be appropriate:

I. In the case of new capital expenditures which serve to add to the value of an existing capital asset, these will be estimated to have the remaining useful life as the asset whose value is enhanced.

II. Freehold land cannot properly have a life attributed to it, so for the purposes of Asset Life method it will be treated as equal to a maximum of 50 years. But if there is a structure on the land which the authority considers to have a life longer than 50 years, that same life estimate will be used for the land.

III. To the extent that expenditures are of a type that are subject to estimated life periods that are referred to in the Guidance, these periods will generally be adopted by the Council. However, in the case of long term debtors (e.g. West London Waste Authority) arising from loans or other types of capital expenditure made by the Council which will be repaid under separate arrangements, there will be no Minimum Revenue Provision made. The Council is satisfied that a prudent provision will be achieved after exclusion of these capital expenditures from the MRP requirements.

Housing Revenue Account (HRA) Major Repairs Allowance (MRA)

73. The National Subsidy system was replaced by Self Financing on 01 April 2012 as part of the Government's reform of the HRA. As a result, the Council will make a charge for deprecation in respect of its dwellings calculated on a componentised basis, which will be counted as a genuine charge against the HRA. Under the National Subsidy system, the Council made a charge equal to the Major Repairs Allowance receivable from Central Government thereby ensuring a nil overall effect for depreciation.

74. The Government has allowed Councils to continue to charge depreciation at an amount equal to the Major Repairs Allowance for the next five years under transitional arrangements to permit Council's to adapt to the new framework. The Council has decided, however, to move to componentised depreciation, as recommended by proper practices, as this gives a fairer reflection of future investment requirements.

75. As the value of housing stock is expected to increase broadly in line with inflation, HRA debt as a proportion of the value of housing stock will decline. If it is considered asset lives are not being sufficiently maintained, provision to repay borrowing will be made and reflected in the HRA Business Plan.

Financial Implications

76. Financial matters are integral to the report.

Legal Implications

77. The report has been reviewed by Legal Department and comments received are incorporated into the report.

Environmental Impact

78. There are no direct environmental impacts.

Performance Issues

79. The Council meets the requirements of the CIPFA Code of Practice for Treasury Management and therefore is able to demonstrate best practices for the Treasury Management function.

Risk Management Implications

80. There is a risk that the Council could lose a deposit due to the failure of a Counterparty and any movement in interest rates will have an impact on the investment income and borrowing costs.

    Risk included on Directorate risk register? Yes
    Separate risk register in place? No

Equalities Implications

81. Officers have considered any possible equalities impact and consider that there is no adverse equalities impact.

Corporate Priorities

82. This report deals with the Treasury Management Strategy which is a key to delivering the Council's corporate priorities

Section 3 - Statutory Officer Clearance

Name: Julie Alderson Date: 21 January 2013	x	Chief Financial Officer
Name: Jessica Farmer Date: 23 January 2013	x	on behalf of the Monitoring Officer

Section 4 – Performance Officer Clearance

Name: Alex Dewsnap Date: 21 January 2013	x	Divisional Director

Section 5 – Environmental Impact Officer Clearance

Name: John Edwards Date: 28 January 2013	x	Divisional Director

Section 6 - Contact Details and Background Papers

Contact: George Bruce (Treasury and Pension Fund Manager, Finance & Procurement) Tel: 020-8424-1170 / Email: george.bruce@harrow.gov.uk

Background Papers: None

Call-In Waived by the Chairman of Overview and Scrutiny Committee	**NOT APPLICABLE** *[Call-in applies, except to the Recommendations to Council]*

Appendix 1

Interest Rates and Economic Background

The Council has appointed Sector as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table gives the Sector central view:

	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%
5yr PWLB rate	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%
10yr PWLB rate	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%
25yr PWLB rate	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%
50yr PWLB rate	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%

<u>The Global economy</u>

The Eurozone debt crisis has continued to cast a pall over the world economy and has depressed growth in most countries. This has impacted the UK economy which is unlikely to grow significantly in 2012 and is creating a major headwind for recovery in 2013. Quarter 2 of 2012 was the third quarter of contraction in the economy; this recession is the worst and slowest recovery of any of the five recessions since 1930. A return to growth of 1% in quarter 3 in unlikely to prove anything more than a washing out of the dip in the previous quarter before a return to weak, or even negative, growth in quarter 4.

The Eurozone sovereign debt crisis has abated somewhat following the ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bailout. Sentiment in financial markets has improved considerably since this ECB action and recent Eurozone renewed commitment to support Greece and to keep the Eurozone intact. However, the foundations to this "solution" to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse.

The US economy has only been able to manage weak growth in 2012 despite huge efforts by the Federal Reserve to stimulate the economy by liberal amounts of quantitative easing (QE) combined with a commitment to a continuation of ultra low interest rates into 2015. However, the housing market does look as if it has, at long last, reached the bottom and house prices are now on the up.

<u>The UK economy</u>

The Government's austerity measures, aimed at getting the public sector deficit into order over the next four years, now look as if they will fail to achieve their objectives within the original planned timeframe.

Currently, the UK is enjoying a major financial benefit from some of the lowest sovereign borrowing costs in the world as the UK is seen as a safe haven from Eurozone debt. There is, though, little evidence that consumer confidence levels are recovering nor that the manufacturing sector is picking up. On the positive side, growth in the services sector has rebounded in Q3 and banks have made huge progress since 2008 in shrinking their balance sheets to more manageable levels and also in reducing their dependency on wholesale funding. However, availability of credit remains tight in the economy and the Funding for Lending scheme, which started in August 2012, has not yet had the time to make a significant impact. Finally, the housing market remains tepid and the outlook is for house prices to be little changed for a prolonged period.

Economic growth has basically flat lined since the election of 2010 and, worryingly, the economic forecasts for 2012 and beyond were revised substantially lower in the Bank of England Inflation quarterly report for August 2012 and were then further lowered in the November Report. Quantitative Easing (QE) was increased again by £50bn in July 2012 to a total of £375bn. The Government's austerity strategy has resulted in a substantial reduction in employment in the public sector. Despite this, total employment has increased to the highest level for four years as over one million jobs have been created in the private sector in the last two years.

Inflation has fallen sharply during 2012 from a peak of 5.2% in September 2011 to 2.2% in September 2012. However, inflation increased back to 2.7% in October though it is expected to fall back to reach the 2% target level within the two year horizon.

The UK continues to enjoy an AAA sovereign rating. However, the credit rating agencies will be carefully monitoring the rate of growth in the economy as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years.

Sector's forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains relatively fragile and whilst there is still a broad range of views as to potential performance, expectations have all been downgraded during 2012.

The focus of so many consumers, corporates and banks on reducing their borrowings, rather than spending, will continue to act as a major headwind to a return to robust growth in western economies.

Given the weak outlook for economic growth, Sector sees the prospects for any changes in Bank Rate before 2015 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. The interest rate forecast in this report represents a balance of downside and upside risks. .

Appendix 2

Treasury Management Delegations and Responsibilities

The respective roles of the Cabinet, GARMC, the Section 151 officer, the Treasury Management Group and the Treasury Team are summarised below. Further details are set out in the Treasury Practice Notes.

The main responsibilities and delegations in respect of treasury activities are:

Council

Council will approve the annual treasury strategy, including borrowing and investment strategies. In doing so Council will establish and communicate their appetite for risk within treasury management having regard to the Prudential Code

Cabinet

Cabinet will recommend to Council the annual treasury strategy, including borrowing and investment strategies and receive a half-year report and annual out-turn report on treasury activities.

Cabinet also approves revenue budgets, including those for treasury activities.

Governance, Audit and Risk Monitoring Committee

GARMC is responsible for ensuring effective scrutiny of the Treasury strategy and policies.

Section 151 Officer

Council has delegated responsibility for the implementation and monitoring of treasury management decisions to the Section 151 Officer to act in accordance with approved policy and practices. In particular, the Sector 151 Officer:

- Approves all new borrowing, investment counterparties and limits and changes to the bank mandate,
- Chairs the Treasury Management Group ("TMG"), and
- Approves the selection of treasury advisor and agrees terms of appointment.

Treasury Management Group

Monitors the treasury activity against approved strategy, policy, practices and market conditions.

Approves changes to treasury management practices and procedures.

Reviews the performance of the treasury management function using benchmarking data on borrowing and investment provided by Sector.

Monitors the performance of the appointed treasury advisor and recommends any necessary actions.

Ensures the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function.

Monitors the adequacy of internal audit reviews and the implementation of audit recommendations.

Treasury and Pension Investment Manager

Has responsibility for the execution and administration of treasury management decisions, acting in accordance with the Council's Treasury Policy Statement and CIPFA's 'Standard of Professional Practice on Treasury Management'.

Treasury Team

Undertakes day to day treasury investment and borrowing activity in accordance with strategy, policy, practices and procedures and recommends changes to these to the TMG.

Appendix 3

Enhanced Cash Funds

1. The potential investment universe is wide and there are many types that Harrow does not currently utilise. One category that we would like to introduce into the portfolio is enhanced cash funds (also known as short dated bond funds). These share many of the characteristics of money market funds, which Harrow already uses:

   - Stand alone fund, mainly a Dublin plc, that invests in bank and corporate bonds, bank deposits and other financial instruments.
   - An appointed fund manager determines which investments to hold.
   - Investment is through the purchase of units.
   - Most have an AAA credit rating.

2. The key difference between money market funds (MMF) and enhanced cash funds (ECF) is the latter are permitted longer maximum average maturities. A rated MMF has a maximum weighted average maturity (WAM) of 60 days, while ECF typically have 360 days WAMs and some longer. This allows them to generate a higher return from buying longer dated securities. As a consequence of the longer WAM, there are a number of differences between MMF and ECF:

   - The value of investments in ECF can vary being based on the underlying value of the investments. In a MMF, any change in value is relatively small and is reflected in the declared income.
   - MMF are dealt daily with cash moving in and out on trade date. With ECF the notice and settlement period can be up to 5 days and the funds are not suitable for intra day liquidity.
   - ECF employ a wider range of instruments and some use derivatives.

3. ECF are attractive to Harrow in that they offer a higher return than MMF and compared with direct investments in bonds offer high levels of diversity while maintaining an overall high quality credit exposure.

4. As mentioned above, most ECF have a credit rating, usually AAA. There is also a separate volatility rating that measures the sensitivity of the value of the fund to changes in interest rates. When market interest rates increase, the impact on the value of longer term investments is higher than short term investments. Despite the longer WAM, many have the lowest volatility ratings because they have strict policies on selling investments when prices change.

5. The attraction of ECF is the higher returns. MMF generally have net returns at present of between 0.3% and 0.6%, where as an ECF with a WAM of 360 days is currently in the range 1% to 2%.

6. The use of such funds has been discussed with the Council’s treasury advisor who are supportive provided the exposure is limited to 20-25% of the total deposits and we invest with higher security / lower volatility funds. We will avoid funds that use derivatives as the legality of these for local authorities is unclear. Implementation will involve both a switch from MMF and bank fixed term deposits. A maximum of £10 million will be invested with a single fund is proposed.