Agenda Item No. **10**

Governance, Audit and Scrutiny Committee 7 March 2016	Report by the Finance Manager

TREASURY MANAGEMENT AND CAPITAL EXPENDITURE PRUDENTIAL INDICATORS, TREASURY MANAGEMENT POLICY STATEMENT 2016/17 AND MINIMUM REVENUE PROVISION (MRP) FOR 2016/17

REPORT EXECUTIVE SUMMARY

This report sets out the Prudential Indicators for Treasury Management and Capital and the Treasury Management Policy Statement proposed for adoption for the financial year 2016/17. The Authority's Constitution requires that the Policy Statement is approved by the full Fire Authority and this responsibility cannot be delegated.

This report also outlines the recommended policy to be adopted in respect of creating the Minimum Revenue Provision (MRP) for 2016/17, in line with the statutory requirements set out in The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008.

RECOMMENDATIONS

1. Members consider the Prudential Indicators for Treasury Management and Capital Expenditure at paragraphs 12 and 13, the MRP calculated for 2016/17 at paragraphs 15-19 and Appendices 1, 2 and 3 of this report as the basis for the Authority's Treasury Management activities in 2016/17 and make any recommendations to the Fire Authority as necessary.

BACKGROUND

2. Treasury Management, as defined by the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice 2011 is:

   'The management of the organisation's investments and cash-flows, its banking and 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'.

3. In the light of the Icelandic situation in 2008, CIPFA amended the CIPFA Treasury Management in the Public Services Code of Practice (the Code), Cross-Sectoral Guidance Notes and Guidance Notes and the template for the revised Treasury Management Policy Statement.

4. It was a requirement of the 2009 Code that this Authority should formally adopt the revised Code; this was formally adopted at the Fire Authority meeting on 15 February 2010.

5. An updated version of the Code was published in November 2011; this strategy statement has been prepared in accordance with the requirements of the new Code.

TREASURY MANAGEMENT AND PRUDENTIAL INDICATORS

6. The Local Government Act 2003 and supporting regulations require the Authority to 'have regard to' the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set, on an annual basis, a range of Prudential and Treasury Indicators for the next three years to ensure that its capital investment plans are affordable, prudent and sustainable. This report details the proposed indicators relating to the Authority's Treasury Management activities, capital expenditure and external debt for 2016/17 for Members' consideration and approval.

7. The suggested strategy for 2016/17 in respect of the following aspects of the treasury management function is based upon the S.151 Officer's views on interest rates, supplemented with leading market forecasts provided by the Authority's treasury management advisors and support from the treasury management team within Hull City Council. The strategy covers:

   - limits in force which will limit the treasury risk and activities of the Authority;
   - the Treasury Management and Prudential Indicators;
   - the current treasury position;
   - prospects for interest rates;
   - the borrowing requirement and strategy;
   - policy on borrowing in advance of need;
   - debt rescheduling;
   - the investment strategy;
   - creditworthiness policy;
   - the MRP strategy;
   - policy on use of external service providers

8. The 2003 Act, revised Investment Guidance issued 2010 and the updated CIPFA Code also require that Members give consideration to the Authority's Annual Investment Strategy, setting out how investments will be managed and the priorities for security and liquidity of those investments as well as the Annual Borrowing Strategy; these have also been incorporated into this report.

9. In addition, it is a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the Authority to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital decisions. This therefore means, that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from:

   a. increased interest charges from additional borrowing and;

   b. increased running costs from new capital projects

are limited to a level that is affordable within the projected income of the Authority.

PRUDENTIAL INDICATORS

10. The Capital Programme for 2016/17 onwards was approved by the Authority on 15 February 2016 and includes details of the proposed funding of the Authority's spending over the next three years. In developing the programme, consideration has been given to the revenue implications both in terms of financing costs and operational costs. The Executive Director Service Support/S.151 Officer views the Authority's capital plans as sustainable and affordable.

11. The Indicators categorised as those relating to the affordability of capital plans and those relating to Treasury Management are shown below for formal approval, including brief explanations and extracts from the Prudential Code.

PRUDENTIAL INDICATORS – CAPITAL EXPENDITURE

12. a) Indicator 1 - Capital Expenditure

The projected capital expenditure for the current year, and estimates of the capital expenditure to be incurred in future years that are recommended for approval are as follows: -

	2015/16 Estimate £k	2016/17 Estimate £k	2017/18 Estimate £k	2018/19 Estimate £k
Total Capital expenditure	5,488	1,901	2,436	2,713

Financial appraisals are now required to ascertain the most prudent, affordable and sustainable method of securing the use of capital assets needed by the Authority. Financing of asset acquisitions will be reviewed prior to commitment.

This capital programme reflects the Authority's strategic requirements; the programme will be monitored as part of the Management Accounts.

b) Indicator 2 - Ratio of Capital Financing Costs to Net Revenue Stream

Estimates of the ratio of financing costs to net revenue stream for the current and future years are as follows: -

	2015/16 Estimate %	2016/17 Estimate %	2017/18 Estimate %	2018/19 Estimate %
Ratio of Finance Costs to Net Revenue Stream	9.91	7.81	5.99	6.30

These ratios indicate the proportion of the net budget of the Authority that is required to finance the costs of capital expenditure in any year. Estimates of financing costs include current commitments, the proposals contained in the capital programme of the Authority and any amounts payable under finance leases.

In calculating the ratio, Net Revenue Streams in any year have been taken to exclude any element of the net budget requirement that is intended to provide reserves for the Authority.

c) Indicator 3 - Capital Financing Requirement (CFR)

Estimates of the end of year capital financing requirement for the Authority for the current and future years are as follows:-

	Estimate 31/03/16 £k	Estimate 31/03/17 £k	Estimate 31/03/18 £k	Estimate 31/03/19 £k
Capital Financing Requirement	17,614	20,290	19,849	20,571

The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Authority's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

Following accounting changes the CFR includes any other long term liabilities (e.g. PFI schemes, finance leases) brought onto the Balance Sheet. Whilst this increases the CFR, and therefore the Authority's borrowing requirement, these types of scheme include a borrowing facility and so the Authority is not required to separately borrow for these schemes.

A key indicator of prudence under the Prudential Code is: -

"In order to ensure that over the medium term net borrowing will only be for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years".

The Authority's 31 March 2017 gross debt position will be £17,858k against a 2016/17 Capital Financing Requirement (CFR) of £20,290k. The Authority based on these projections would be internally borrowed by 31 March 2017 and any decision to take additional borrowing during the financial year will be driven by the actual rate of capital expenditure and the very latest projections for interest rates.

d) Indicator 4 - Incremental Impact of Capital Investment decisions

The estimate of the incremental impact of capital investment decisions proposed in this budget report, over and above capital investment decisions that have previously been taken by the Authority are as follows: -

	2016/17 Estimate £	2017/18 Estimate £	2018/19 Estimate £
Impact for Band D Council Tax	(0.17)	0.56	0.63

In considering its programme for capital investment, the Authority is required within the Prudential Code to have regard to: -

Affordability – e.g. implications for Council Tax
Prudence and sustainability – e.g. implications for external borrowing
Value for money – e.g. option appraisal
Stewardship of assets – e.g. asset management planning
Service objectives – e.g. strategic planning for the Authority
Practicality – e.g. achievability of the forward plan

A key measure of affordability is the incremental impact on the Council Tax, which in practice will depend on individual financing decisions taken in circumstances which pertain at the time. Each project will be appraised before commitment.

PRUDENTIAL INDICATORS – TREASURY MANAGEMENT

13. a) Indicator 5 - Authorised Limit for External Debt

In respect of its external debt, it is recommended that the Authority approves the following authorised limits for its total external debt gross of investments for the period 2016/17 to 2018/19. These limits separately identify borrowing from other long-term liabilities such as finance leases. The Authority is asked to approve these limits and to delegate to the S.151 Officer, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long term liabilities, in accordance with option appraisal and value for money for the Authority. Any such changes made will be reported to the Authority at its next meeting following the change.

	2015/16 Estimate £k	2016/17 Estimate £k	2017/18 Estimate £k	2018/19 Estimate £k
Borrowing	27,600	27,600	27,400	27,200
Other Long Term Liabilities	678	466	278	94
	28,278	28,066	27,678	27,294

The Authorised Limit has been compiled in line with the revised requirements of the Code.

The S.151 Officer reports that these authorised limits are consistent with the Authority's current commitments, existing plans and the proposals in the budget report for capital expenditure and financing, and with its approved Annual Investment Strategy and Treasury Management Policy Statement and Practices. The S.151 Officer confirms that they are based on the estimate of most likely, prudent but not worst case scenario, with sufficient headroom over and above this to allow for operational management of, for example unusual cash movements. Risk analysis and risk management strategies have been taken into account, as have plans for capital expenditure, estimates of the capital financing requirement and estimates of cash flow requirements for all purposes.

b) Indicator 6 - Operational Boundary for External Debt

The proposed operational boundary for external debt is based on the same estimates as the authorised limit but reflects directly the S.151 Officer's estimate of the most likely, prudent but not worst case scenario, without the additional headroom included within the authorised limit to allow for example for unusual cash movements, and equates to the maximum of external debt projected by this estimate. The operational boundary represents a key management tool for in year monitoring by the S.151 Officer. Within the operational boundary, figures for borrowing and other long term liabilities are separately identified. The Authority is also asked to approve the operational boundary and to delegate authority to the S.151 Officer, within the total operational boundary for the year, to effect movement between the separately agreed figures for borrowing and other long term liabilities, in a similar fashion to the authorised limit. Any such changes will be reported to the Authority at its next meeting following the change.

	2015/16 Estimate £k	2016/17 Estimate £k	2017/18 Estimate £k	2018/19 Estimate £k
Borrowing	21,600	21,600	21,400	21,200
Other Long Term Liabilities	678	466	278	94
	22,278	22,066	21,678	21,294

The Authority's actual external debt at 31 March 2015 was £16.620m, all of which related to borrowing for capital purposes.

It should be noted that actual external debt is not directly comparable to the Authorised Limit and Operational Boundary, since the actual external debt reflects the position at one point in time.

In taking its decisions on this report, the Authority is asked to note that the Authorised Limit determined for 2015/16 (see above) will be the statutory limit determined under section 3 (1) of the Local Government Act 2003.

c) Indicator 7 – Fixed and Variable Rate Exposure

This indicator seeks to ensure that the Authority limits its exposure to the risk of interest rate changes and the consequent impact on the investment income and interest payments on loans, by restricting the proportion of variable rate borrowing.

The Authority will set for the forthcoming financial year and the following two financial years, upper limits to its exposure to the effects of changes in interest rates. These prudential indicators will relate to both fixed interest rates and variable interest rates

and be referred to respectively as the upper limits on fixed interest rates and variable interest rate exposures.

	Actual as at 31/1/16	2016/17	2017/18	2018/19
	%	%	%	%
Fixed rate %	100	-	-	-
Fixed Rate – maximum %	-	100	100	100
Fixed Rate - minimum %		75	75	75
Variable Rate – maximum % limit	-	25	25	25

This means that the Executive Director Service Support/S.151 Officer will manage fixed rate exposures within the range 75% to 100% of the portfolio and variable rate exposures will be limited to a maximum of 25% of the portfolio. This is a continuation of current practice, which has proved satisfactory thus far.

d) Indicator 8 – Upper and Lower Limits for the maturity structure of borrowings

"The Authority will set for the forthcoming financial year both upper and lower limits with respect to the maturity structure of its borrowings. The prudential indicators will be referred to as the upper and lower limits respectively for the maturity structure of borrowing and shall be calculated as follows:

> Amount of projected borrowing that is fixed rate maturing in each period expressed as a percentage of total projected borrowing that is fixed rate, where the periods in question are:
>
> - Under 12 months
> - 12 months and within 24 months
> - 24 months and within 5 years
> - 5 years and within 10 years
> - 10 years and above"

The indicator also seeks to ensure the Authority controls its exposure to the risk of interest rate changes by limiting the proportion of debt maturing in any single period. Ordinarily debt is replaced on maturity and therefore it is important that the Authority is not forced to replace a large proportion of loans at a time of relatively high interest rates.

	Actual as at 31/1/16 %	Upper Limit %	Lower Limit %
Under 12 Months	2.71	15	0
12 months and within 24 months	9.07	15	0
24 months and within 5 years	13.45	25	0
5 years and within 10 years	33.08	60	0
10 years and above	41.69	80	0

e) Indicator 9 – Upper limit for maturity structure of investments

"Where an Authority invests, or plans to invest, for periods longer than 364 days, the Authority will set an upper limit for each forward financial year period for the maturing of such investments. These prudential indicators will be referred to as prudential limits for principal sums invested for periods longer than 364 days and shall be calculated as follows:

> Total principal invested to final maturities beyond the period end."

Under the Prudential Regime Authorities are free to invest for periods of greater than 1 year. This indicator sets restrictions on the proportion of investments committed for longer periods in order to limit the risks associated with being unable to meet unexpected cash flows and/or being able to take advantage of future increases in interest rates.

	Actual as at 31/1/16 %	Upper Limit %
Under 12 Months	100	100
12 months and within 24 months	0	0
24 months and within 3 years	0	0
3 years and within 4 years	0	0
4 years and within 5 years	0	0
5 years and above	0	0

This Authority does not have a major investment portfolio and generally is investing temporarily cash assets which currently do not need to be applied to further the Authority's service and financial plans. Security and liquidity are particularly desirable given the current economic climate therefore there are no proposals at present to invest for a period of longer than 364 days; this is therefore the proposed upper limit.

The above indicators will be monitored by the Executive Director Service Support/S.151 Officer against Treasury activity and performance will be formally reported (together with performance against the approved indicators for Capital Expenditure and External Debt) to Members monthly as part of the Authority's Management Accounts booklet.

f) Indicator 10 – Maximum limit of net debt as a proportion of gross debt

	2016/17 Limit £k	2017/18 Limit £k	2018/19 Limit £k
Gross Debt	27,600	27,400	27,200
Investments	17,000	17,000	17,000
Net Debt	10,600	10,400	10,200

This is a new indicator introduced in the 2011 Code.

TREASURY MANAGEMENT POLICY STATEMENT

14. a) The 2016/17 Statement, which is included at Appendix 1, covers:

- the current treasury position;
- prospects for interest rates;
- the borrowing strategy;
- debt rescheduling;
- the investment strategy;
- delegations to Executive Director Service Support/S.151 Officer

b) The investment instruments which it is intended to utilise during 2016/17 are set out at Appendix 2 and the organisations to which the Authority will lend are detailed at Appendix 3.

MINIMUM REVENUE PROVISION (MRP)

15. MRP represents the amount that local authorities must set aside each year from their revenue budget as a provision for the repayment of debt.

16. As previously reported to Members, a change in statute governing the creation of MRP came into force on 31 March 2008. Under regulation 27, 28, and 29 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 [SI 2003/3146, as amended], the Authority was previously required to make an annual MRP of 4% of its Capital Financing Requirement (CFR), with a slight adjustment for a variation in the Adjusted Credit ceiling. Regulation 4(1) of the 2008 regulations revises the requirements of paragraph 28 of the above statute and instead introduces the requirement for local authorities to make ‘prudent’ provision for the repayment of debt from 2007/08 onwards.

17. Four suggested options are outlined within the legislation inclusive of transitional arrangements, although authorities may follow alternative approaches so long as they can demonstrate they are prudent. The four options are:

    a) <u>Option 1 – Regulatory Method</u>
    MRP calculated at 4% CFR with an adjustment for variation in the credit ceiling.

    b) <u>Option 2 – CFR Method</u>
    A straight 4% of the Authority’s CFR.

    For 2009/10 onward Options 1 & 2 may only be used for supported capital expenditure and previously incurred debt.

    c) <u>Option 3 – Asset Life Method</u>
    This is the recommended option for unsupported capital expenditure under the Prudential system, with two methods possible:

    (i) equal instalment of principal – set aside an equal amount of MRP each year over the life of the asset.

    (ii) annuity method – MRP calculated according to the flow of benefits from the asset, requiring calculation based on interest on loan repayments

    d) <u>Option 4 – Depreciation Method</u>
    MRP is calculated in line with depreciation policy.

18. At the meeting of the Fire Authority on 30 June 2008, Members agreed the use of Option 1 as a prudent MRP policy for application in 2007/08 and 2008/09, and have in subsequent years agreed the use of Option 3 (i) as the preferred basis of calculation for new unsupported capital expenditure.

19. For 2016/17 it is proposed that Option 3 (i) is again adopted for calculating the required MRP provision for any new unsupported capital expenditure in line with the recommendations contained in the guidance and prudence. Adopting this policy will result in an MRP of £1.733m for 2016/17. This has been incorporated into the Medium-Term Financial Plan for 2016/17 onwards.

STRATEGIC PLAN COMPATIBILITY

20. Treasury Management is an integral part of the financial management of the Authority with Prudential Indicators providing a framework for the Authority to monitor key elements of its financial position. Utilising approved Borrowing and Investment Strategies, the Executive Director Service Support/S.151 Officer will seek to minimise

borrowing costs and maximise investment income whilst adopting a prudent approach to the Authority's exposure to market risks, especially given the current economic situation.

FINANCIAL/RESOURCES/VALUE FOR MONEY IMPLICATIONS

21. The approach outlined within the report is aimed at achieving effective and efficient management of the Authority's financial resources and reflects a prudent approach to the management of financial risk for the Authority.

LEGAL IMPLICATIONS

22. The Authority must comply with the requirements of the CIPFA Code of Practice on Treasury Management and the Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008. This report ensures such compliance.

EQUALITY IMPACT ASSESSMENT/HR IMPLICATIONS

23. No direct issues arising from this report.

CORPORATE RISK MANAGEMENT IMPLICATIONS

24. The formulation and application of a prudent Treasury Management Policy and MRP provision ensures that the Authority effectively manages financial risks such as exposure to interest rate changes and liquidity risk whilst minimising borrowing costs and maximising investment income. It further ensures that sufficient levels of resource are set aside for the repayment of debt. Effective treasury management is key to making the best use of the Authority's financial resources and thus the successful delivery of its Strategic Plan.

HEALTH AND SAFETY IMPLICATIONS

25. No direct issues arising.

COMMUNICATIONS ACTIONS ARISING

26. No direct issues arising.

DETAILS OF CONSULTATION

27. No direct issues arising.

BACKGROUND PAPERS AVAILABLE FOR ACCESS

28. 2016/17 Budget and Precept and Medium-Term Financial Plan 2016/17 to 2018/19 – Report to Fire Authority 15 February 2016
Financial Planning 2016/17 Onwards – Report to Fire Authority 11 December 2015
Treasury Management Mid-year Update Report 2015/16 – Report to Fire Authority 11 December 2015
CIPFA Prudential Code (Revised 2011) and November 2012 update
The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008.

RECOMMENDATIONS RESTATED

29. Members consider the Prudential Indicators for Treasury Management and Capital Expenditure at paragraphs 12 and 13, the MRP calculated for 2016/17 at paragraphs 15-19 and Appendices 1, 2 and 3 of this report as the basis for the Authority's Treasury Management activities in 2016/17 and make any recommendations to the Fire Authority as necessary.

M RANSOM

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24 February 2016

Treasury Management Policy Statement 2016/17

1. Introduction

This organisation defines its treasury management activities as:
'The management of the organisation's investments and cash-flows, its banking and 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.'

The Authority 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.

Humberside Fire Authority acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management and to employing suitable, comprehensive performance measurement techniques, within the context of effective risk management.

This Policy Statement incorporates:

- The current treasury position;
- Prospects for interest rates;
- The Borrowing Strategy;
- Policy on borrowing and borrowing in advance of need;
- Debt rescheduling;
- The Investment Strategy;
- Creditworthiness policy
- Delegations to the Executive Director Service Support/S.151 Officer

2. Current Treasury Position

The Authority's treasury portfolio position at 31/1/16 is detailed below.

	£'000
Fixed Rate Borrowing	15,420
Variable Rate Borrowing	-
Total Borrowing	15,420
Total Investments	17,000

3. Prospects for Interest Rates

The Authority's treasury advisors, Capita Asset Services have provided the following table on Forecast interest and borrowing rates:

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Mar 2016	0.50	2.00	3.40	3.20
Jun 2016	0.50	2.10	3.40	3.20
Sep 2016	0.50	2.20	3.50	3.30
Dec 2016	0.50	2.30	3.60	3.40
Mar 2017	0.75	2.40	3.70	3.50
Jun 2017	0.75	2.50	3.70	3.60
Sep 2017	1.00	2.60	3.80	3.70
Dec 2017	1.00	2.70	3.90	3.80
Mar 2018	1.25	2.80	4.00	3.90
Jun 2018	1.50	2.90	4.00	3.90
Sep 2018	1.50	3.00	4.10	4.00
Dec 2018	1.75	3.10	4.10	4.00
Mar 2019	2.00	3.20	4.10	4.00

PWLB = Public Works Loan Board (provider of loans to Local Authorities and other bodies)

Capita Asset Services current interest rate view is that Bank Rate: -

- **Is forecast to commence rising in Quarter 1 of 2017**
- **It is then expected to continue rising steadily from thereon**

4. Economic Background

UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and although the 2015 growth rate is likely to be a leading rate in the G7 again, it looks likely to disappoint previous forecasts and come in at about 2.2%.

Quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a slight increase in quarter 2 to +0.5% (+2.3% y/y) before weakening again to +0.4% (2.1% y/y) in quarter 3 followed by a slight recovery in quarter 4 to an initial reading of +0.5%.

The February Bank of England Inflation Report included a forecast for growth to remain around 2.2% – 2.4% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero since February 2015.

However, these forecasts are approximately 0.2% lower than those of the November Inflation Report. Investment expenditure is also expected to support growth. However, since the second half of 2015, most worldwide economic statistics have been weak and financial markets have been particularly volatile in early 2016.

The November Inflation Report flagged up particular concerns for the potential impact of these factors on the UK and this theme was maintained in the February Inflation Report.

The February Inflation Report was notably subdued in respect of the forecasts for inflation in the near-term; this was expected to barely get back up to the 1% level within the next 12 months but was expected to marginally exceed the 2% target on the 2-3 year time horizon.

The increase in the November Inflation Report forecast for inflation at the three year horizon was the biggest in a decade and at the two year horizon was the biggest since February 2013.

However, the first round of falls in oil, gas and food prices over late 2014 and also in the first half 2015, will fall out of the 12 month calculation of CPI during late 2015 / early 2016 but a second, more recent round of falls in fuel and commodity prices will delay a significant tick up in inflation from around zero.

There is, therefore, considerable uncertainty around how quickly pay and CPI inflation will rise in the next few years and this makes it difficult to forecast when the MPC will decide to make a start on increasing Bank Rate.

There is also the uncertain impact of the EU referendum which may take place in June 2016.

The weakening of UK GDP growth during 2015 and the deterioration of prospects in the international scene, especially for emerging market countries, have consequently led to forecasts for when the first increase in Bank Rate would occur being pushed back to quarter 1 of 2017. There is downside risk to this forecast i.e. it could be pushed further back and the markets are currently betting on a quarter 1 2018 increase.

USA. The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015, but then pulled back to 2.0% in quarter 3 and retreated to +0.7% in quarter 4.

However, the uninterrupted run of strong monthly increases in non-farm payrolls figures for growth in employment in 2015 prepared the way for the Fed. to embark on its long awaited first increase in rates of 0.25% at its December meeting.

However, the accompanying message with this first increase was that further increases will be at a much slower rate, and to a much lower ultimate ceiling, than in previous business cycles, mirroring comments by our own MPC.

EZ. In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries.

This programme of €60bn of monthly purchases started in March 2015 and it was intended to run initially to September 2016. At the ECB's December meeting, this programme was extended to March 2017 but was not increased in terms of the amount of monthly purchases.

The ECB also cut its deposit facility rate by 10bps from -0.2% to -0.3%. This programme of monetary easing has had a limited positive effect in helping a recovery in consumer and business confidence and a start to some improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.3% y/y) but has then eased back to +0.4% (+1.6% y/y) in quarter 2 and to +0.3% (+1.6%) in quarter 3.

Financial markets were disappointed by the ECB's lack of more decisive action in December and it is likely that it will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

Greece. During July, Greece finally capitulated to EU demands to implement a major programme of austerity and is now cooperating fully with EU demands. An €86bn third bailout package has since been agreed though it did nothing to address the unsupportable size of total debt compared to GDP.

However, huge damage has been done to the Greek banking system and economy by the resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so Greek exit from the euro may only have been delayed by this latest bailout.

Portugal and Spain. The general elections in September and December respectively have opened up new areas of political risk where the previous right wing reform-focused pro-austerity mainstream political parties have lost their majority of seats.

An anti-austerity coalition has won a majority of seats in Portugal while the general election in Spain produced a complex result where no combination of two main parties is able to form a coalition with a majority of seats. It is currently unresolved as to what administrations will result from both these situations.

This has created nervousness in bond and equity markets for these countries which has the potential to spill over and impact on the whole Eurozone project.

Investment returns are likely to remain relatively low during 2016/17 and beyond;

Borrowing interest rates have been highly volatile during 2015 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. Gilt yields have continued to remain at historically phenominally low levels during 2015.

The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times, when authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt.

There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country;

The 2014 growth rate was also the strongest UK rate since 2006 and although the 2015 growth rate is likely to be a leading rate in the G7 again, it looks likely to disappoint previous forecasts and come in at about 2.2%.

Quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a slight increase in quarter 2 to +0.5% (+2.3% y/y) before weakening again to +0.4% (2.1% y/y) in quarter 3 followed by a slight recovery in quarter 4 to an initial reading of +0.5%.

The February Bank of England Inflation Report included a forecast for growth to remain around 2.2% – 2.4% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero since February 2015.

However, these forecasts are approximately 0.2% lower than those of the November Inflation Report. Investment expenditure is also expected to support growth. However, since the second half of 2015, most worldwide economic statistics have been weak and financial markets have been particularly volatile in early 2016.

The November Inflation Report flagged up particular concerns for the potential impact of these factors on the UK and this theme was maintained in the February Inflation Report.

The February Inflation Report was notably subdued in respect of the forecasts for inflation in the near-term; this was expected to barely get back up to the 1% level within the next 12 months but was expected to marginally exceed the 2% target on the 2-3 year time horizon.

The increase in the November Inflation Report forecast for inflation at the three year horizon was the biggest in a decade and at the two year horizon was the biggest since February 2013.

However, the first round of falls in oil, gas and food prices over late 2014 and also in the first half 2015, will fall out of the 12 month calculation of CPI during late 2015 / early 2016 but a second, more recent round of falls in fuel and commodity prices will delay a significant tick up in inflation from around zero.

There is, therefore, considerable uncertainty around how quickly pay and CPI inflation will rise in the next few years and this makes it difficult to forecast when the MPC will decide to make a start on increasing Bank Rate. There is also the uncertain impact of the EU referendum which will take place in June 2016.

The weakening of UK GDP growth during 2015 and the deterioration of prospects in the international scene, especially for emerging market countries, have consequently led to forecasts for when the first increase in Bank Rate would occur being pushed back to quarter 1 of 2017.

There is downside risk to this forecast i.e. it could be pushed further back and the markets are currently betting on a quarter 1 2018 increase.

USA. The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015, but then pulled back to 2.0% in quarter 3 and retreated to +0.7% in quarter 4.

However, the uninterrupted run of strong monthly increases in non-farm payrolls figures for growth in employment in 2015 prepared the way for the Fed. to embark on its long awaited first increase in rates of 0.25% at its December meeting. However, the accompanying message with this first increase was that further increases will be at a much slower rate, and to a much lower ultimate ceiling, than in previous business cycles, mirroring comments by our own MPC.

EZ. In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries.

This programme of €60bn of monthly purchases started in March 2015 and it was intended to run initially to September 2016. At the ECB's December meeting, this programme was extended to March 2017 but was not increased in terms of the amount of monthly purchases.

The ECB also cut its deposit facility rate by 10bps from -0.2% to -0.3%. This programme of monetary easing has had a limited positive effect in helping a recovery in consumer and business confidence and a start to some improvement in economic growth.

GDP growth rose to 0.5% in quarter 1 2015 (1.3% y/y) but has then eased back to +0.4% (+1.6% y/y) in quarter 2 and to +0.3% (+1.6%) in quarter 3. Financial markets were disappointed by the ECB's lack of more decisive action in December and it is likely that it will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

Greece. During July, Greece finally capitulated to EU demands to implement a major programme of austerity and is now cooperating fully with EU demands. An €86bn third bailout package has since been agreed though it did nothing to address the unsupportable size of total debt compared to GDP.

However, huge damage has been done to the Greek banking system and economy by the resistance of the Syria Government, elected in January, to EU demands. The surprise general election in September gave the Syria government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so Greek exit from the euro may only have been delayed by this latest bailout.

Portugal and Spain. The general elections in September and December respectively have opened up new areas of political risk where the previous right wing reform-focused pro-austerity mainstream political parties have lost their majority of seats.
An anti-austerity coalition has won a majority of seats in Portugal while the general election in Spain produced a complex result where no combination of two main parties is able to form a coalition with a majority of seats. It is currently unresolved as to what administrations will result from both these situations.

This has created nervousness in bond and equity markets for these countries which has the potential to spill over and impact on the whole Eurozone project.

- Investment returns are likely to remain relatively low during 2016/17 and beyond;
- Borrowing interest rates have been highly volatile during 2015 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. Gilt yields have continued to remain at historically phenominally low levels during 2015. The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times, when authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt;
- There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

The S.151 Officer's view broadly concurs with the views of Capita Asset Services but would like to remind Members of the continuing volatility in the market and that there are still a great many influences that could impact on bank rates.

5. Borrowing Strategy

The Authority's 31 March 2017 gross debt position will be £17,858k against an estimated 2016/17 Capital Financing Requirement (CFR) of £20,290k. The Authority based on these projections would be internally borrowed by 31 March 2017 and any decision to take additional borrowing during the financial year will be driven by the actual rate of capital expenditure and the very latest projections for interest rates.

6. Policy on borrowing and borrowing in advance of need

The Authority 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 Authority can ensure the security of such funds.
In determining whether borrowing will be undertaken in advance of need the Authority will:

- ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to take funding in advance of need;
- ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered;
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow;
- consider the merits and demerits of alternative forms of funding;
- consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use.

7. Debt Rescheduling

As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings;
- helping to fulfil the treasury strategy;
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

All rescheduling will be reported to the Authority, at the earliest meeting following its action

8. <u>Annual Investment Strategy</u>

<u>Investment Policy</u>

The Authority will have regard to DCLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIFPA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Authority's investment priorities will be security first, liquidity second, then return.

The Authority will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Authority is low in order to give priority to security of its investments and the aim of the Strategy is to generate a list of highly creditworthy counterparties which will allow diversification and thus avoidance of concentration risk.

The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Authority will not engage in such activity.

Investment instruments identified for use in the financial year are listed below under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Authority's Treasury Management Practices – shown in Appendix 3.

Importantly the acquisition of share capital or loan capital in any body corporate is defined as capital expenditure under Section 16(2) of the Local Government Act 2003. Such investments will have to be funded out of capital or revenue resources and will be classified as 'non-specified investments'. As a result no such investment instruments, such as equities, are included within Appendix 2.

<u>Investment Objectives</u>

The general policy objective for this Authority is the prudent investment of its treasury balances. This includes monies borrowed for the purpose of expenditure in the reasonably near future (i.e. borrowed 12-18 months in advance of need). The Authority's investment priorities are:

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

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

Creditworthiness policy and Approved Lending List

To enable the Treasury Management activity to be carried out on a daily basis, it is necessary for the Authority to approve organisations in which surplus funds can be invested. Appendix 3 recommends a list of such types of organisations to be used during 2016/17 and sets out the maximum amount, which can be invested in each applicable organisation individually. Where an organisation has subsidiaries, it is recommended that, to minimise the Authority's exposure, the limits are set for the group as a whole.

As previously reported to Members, the Authority has revised its methods of assessing institutional risk in conjunction with advice from its Treasury Management advisors Capita Asset Services and in line with the recommendations contained within the revised Code.

The Authority uses the creditworthiness service provided by its advisor Capita Asset Services. This service has been progressively enhanced and now uses a sophisticated modelling approach with credit ratings from all three rating agencies; Fitch, Moody's and Standard and Poor's forming the core element. However, it does not rely solely on the current credit ratings of counterparties but also uses the following as overlays: -

- credit watches and credit outlooks from credit rating agencies;
- CDS spreads to give early warning of likely changes in credit ratings;
- sovereign ratings to select counterparties from only the most creditworthy countries.

Credit ratings are used by investors as indications of the likelihood of getting their money back in accordance with the terms on which they invested. For short term investments, FITCH IBCA rates each organisation by one of the following:

F1+	exceptionally strong credit quality
F1	high credit quality
F2	good credit quality
F3	fair credit quality
B	some risk of default
C	high risk of default
D	will, or has already, defaulted

Long term ratings are also provided with "AAA" being the strongest and "D" the weakest.

The recommended criteria and lending limits for counterparties are shown in Appendix 3.

Using Capita Asset Services' modelling approach combining credit ratings, credit watches, credit outlooks and CDS spreads in a weighted scoring system results in a series of colour code bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Authority to determine the duration for investments and are therefore referred to as durational bands. The Authority is satisfied that this service now gives a much improved level of security for its investments. It is also a service which the Authority would not be able to replicate using in house resources.

The selection of counterparties with a high level of creditworthiness will be achieved by selection of institutions down to a minimum durational band within Capita Asset Services' weekly credit list of worldwide potential counterparties.

All credit ratings will be monitored on a weekly basis using Capita Asset Services' weekly lists, supplemented by daily review of any updates provided. The Authority is alerted to changes to ratings of all three agencies through its use of the Capita Asset Services creditworthiness service.

- If a downgrade results in the counterparty/investment scheme no longer meeting the Authority's minimum criteria, its further use as a new investment will be withdrawn immediately.

- In addition to the use of Credit Ratings the Authority will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Authority's lending list.

Sole reliance will not be placed on the use of this external service. In addition this Authority will also use market data and information, information on government support for banks and the credit ratings of that government support.

It should be noted that the selecting of organisations in this way is not infallible, as recent events have highlighted. It is however, a justifiable method of selection, and when taken together with a maximum limit of £3M with any one organisation is considered prudent. This maximum limit equates to approximately 15% of the funds the Authority expects to have invested during 2016/17.

It is proposed to have a single exception to the £3M limit. For investments placed with the Debt Management Office (DMO), which it is proposed has no limit (as the DMO is part of Government). This would allow the Authority greater flexibility in placing investments with suitable institutions

Investment balances / Liquidity of investments

Based on its cash flow forecasts, the Authority anticipates its fund balances during 2016/17 to start at about £18M.

100% of the Authority's investments will continue to be held in short-term deposits, i.e. maturing within 12 months.

Investment Strategy

Investments will accordingly be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates. All investment will be held within 364 days, taking advice from Capita Asset Services' creditworthiness service on maximum investment durations.

End of year Investment Report

At the end of the financial year, the Executive Director Support Services/S.151 Officer will prepare a report on investment activity as part of the Annual Treasury Report.

9. Policy on the use of external service providers

The Authority uses Capita Asset Services as its external treasury management advisors.

In addition, day-to-day management of the Authority's investment and borrowing transactions are undertaken by the Treasury Management section within Hull City Council. Officers from this team will comply with the Authority's Treasury Management Strategy when arranging transactions on behalf of the Authority. An SLA is in place between HFRS and Hull City Council to formalise the arrangement.

The Authority recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

10. Role of the Section 151 Officer and Delegated Powers

The S.151 Officer will be responsible for:

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance
- submitting regular treasury management policy reports
- submitting budgets and budget variations
- receiving and reviewing management information reports
- reviewing the performance of the treasury management function
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function
- ensuring the adequacy of internal audit, and liaising with external audit
- recommending the appointment of external service providers.

The Executive Director Support Services/S.151 Officer has the delegated powers to manage all money market, banking and similar transactions including the taking of loans and the placing of investments.

Appendix 2

All investments listed below will be sterling-denominated.

SPECIFIED INVESTMENTS

Investment	**Share/Loan Capital?**	**Repayable/ Redeemable Within 12 Months?**	**Security/ Credit Rating**	**Capital Expenditure?**	**Circumstance of Use**	**Maximum period**
Term deposits with the UK government or with English local authorities (i.e. local authorities as defined under Section 23 of the 2003 Act) with maturities up to 1 year	No	Yes	High security although LA's not credit rated.	NO	In-house	1 year
Term deposits with credit-rated deposit takers (banks and building societies), including callable deposits, with maturities up to 1 year	No	Yes	See Appendix 3 for details.	NO	In-house	1 year
Money Market Funds *These funds do not have any maturity date*	No	Yes	AAA	NO	In-house	The period of investment may not be determined at the outset but would be subject to cash flow and liquidity requirements

Monitoring of credit ratings: All credit ratings will be monitored weekly. If a counterparty or investment scheme is downgraded with the result that it no longer meets the Authority's minimum credit criteria, the use of that counterparty/investment scheme will be withdrawn for future transactions.

NON-SPECIFIED INVESTMENTS

All investments listed below must be sterling-denominated.

Investment	(A) Why use it? (B) Associated risks?	Share/ Loan Capital ?	Repayable/ Redeemable Within 12 Months?	Security/ Min. credit Rating **	Capital Spend?	Circumstance of Use	Max % of Overall Investment	Maximum Maturity of Investment
Term deposits with credit rated deposit takers (banks and building societies) with maturities greater than 1 year	(A) (i) Certainty of rate of return over period invested. (ii) No movement in capital value of deposit despite changes in interest rate environment. (B) (i) Illiquid: as a general rule, cannot be traded or repaid prior to maturity. (ii) Return will be lower if interest rates rise after making the investment. (iii) Credit risk : potential for greater deterioration in credit quality over longer period	No	No	Varied – See Appendix 3	NO	To be used in-house but only following consultation with the Executive Director Service Support/S.151 Officer	0%	5 Years

Callable deposits with credit rated deposit takers (banks and building societies) with maturities greater than 1 year	(A) (i) Enhanced income ~ Potentially higher return than using a term deposit with similar maturity. (B) (i) Illiquid – only borrower has the right to pay back deposit; the lender does not have a similar call. (ii) period over which investment will actually be held is not known at the outset. (iii) Interest rate risk: borrower will not pay back deposit if interest rates rise after deposit is made.	No	No	See Appendix 3	NO	To be used in-house but only following consultation with the Executive Director Service Support/S.151 Officer	0%	5 years
Forward deposits with credit rated banks and building societies for periods > 1 year (i.e. negotiated deal period plus period of deposit)	(A) (i) Known rate of return over period the monies are invested ~ aids forward planning. (B) (i) Credit risk is over the whole period, not just when monies are actually invested. (ii) Cannot renege on making the investment if credit rating falls or interest rates rise in the interim period.	No	No	See Appendix 2	NO	To be used in-house only after consultation/ with the Executive Director Service Support/S.151 Officer	0%	5 years

Appendix 3

APPROVED ORGANISATIONS FOR ONLENDING OF SURPLUS FUNDS

BANKS AND BUILDING SOCIETIES

Institution	FITCH IBCA short term rating	Lending Limit
UK Clearing banks and subsidiaries and counterparties in AAA Sovereign rated non-Eurozone countries	F1+	£3m
UK Clearing banks and subsidiaries	F1	£2m
UK Building societies	F1+	£3m
UK Building societies	F1	£2m

Notes:

1. Where an organisation remains as either F1+ or F1 rated, but its CDS status is categorised by Capita Asset Services as ‘monitoring’, investments will not exceed Capita Asset Services’ recommended duration.

2. Where CDS data is categorised as ‘out of range’ there will be no further investment until such time as it falls back within range.

DEBT MANAGEMENT OFFICE (DMO) ACCOUNT £No limit

OTHER LOCAL, FIRE & POLICE AND CRIME COMMISSIONERS £2m limit (each)

MONEY MARKET FUNDS £1m limit (each)*

* Subject to maximum investment in total of £3M

Individual Lending Limits will be kept under review and may in future be revised based on the overall level of investments held by the Authority.