Buckinghamshire & Milton Keynes Fire Authority

MEETING	Executive Committee
DATE OF MEETING	5 February 2014
OFFICER	David Skinner, Director of Finance and Assets
LEAD MEMBER	Councillor Andy Dransfield
SUBJECT OF THE REPORT	**Treasury Management**
EXECUTIVE SUMMARY	This report is being presented as the Fire Authority is required to approve the Treasury Management Policy Statement, Treasury Management Strategy Statement and the Annual Investment Strategy. These documents (Appendix A) all support the Medium Term Financial Plan. The changes of note are: 1. That the counterparty limit for Lloyds is increased from £5 million to £7.5 million; 2. That a limited number of non-UK based banks are added to the counterparty list; and 3. That a limited number of additional UK based building societies are added to the counterparty list.
ACTION	Decision.
RECOMMENDATIONS	That the Authority be recommended to approve the Treasury Management Policy Statement, Treasury Management Strategy Statement and the Annual Investment Strategy for 2014/15.
RISK MANAGEMENT	Making investments in the Authority's own name means that the Authority bears the risk of any counterparty failure. This risk will be managed in accordance with the strategy and with advice from external treasury management advisors. The Director of Finance and Assets will act in accordance with the Authority's policy statement; treasury management practices and CIPFA's Standard of Professional Practice on Treasury Management. There are no direct staffing implications.

FINANCIAL IMPLICATIONS	The projected interest for 2014/15 is likely to be significantly lower than the projected outturn for 2013/14. However, it is still anticipated that the current budget of £70k is achievable, providing there is no significant worsening of the interest rate environment or a large decrease in cash balances. Detailed information is shown within Appendix A.
LEGAL IMPLICATIONS	The Authority is required by section 15(1) of the Local Government Act 2003 to have regard to the Department for Communities and Local Government Guidance on Local Government Investments; and by regulation 24 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 [SI 3146]to have regard to any prevailing CIPFA Treasury Management Code of Practice.
HEALTH AND SAFETY	No direct impact.
EQUALITY AND DIVERSITY	No direct impact.
USE OF RESOURCES	The projected income has been factored into the Medium Term Financial Plan.
PROVENANCE SECTION & BACKGROUND PAPERS	Treasury Management Strategy and Policy Statements 2012/13 http://www.bucksfire.gov.uk/NR/rdonlyres/99BE21DF-99EB-42E2-A9C7-8846A6E3F112/0/BMKFA13022013.pdf (page 31 – 42) Treasury Management Practices http://www.bucksfire.gov.uk/NR/rdonlyres/FDA454EA-1735-4569-BE96-C1E3D0079A75/0/ITEM6TreasuryManagementPracticesandASep13andAnnexA.pdf CIPFA Code of Practice for Treasury Management in the Public Services (CIPFA Code). Department for Communities and Local Government Guidance on Local Government Investments (DCLG Guidance). This paper should also be read in conjunction with the paper "The Prudential Code, prudential indicators and minimum revenue provision" and "Treasury Management Performance 2013-14 – Quarter 3".

APPENDICES	Appendix A – Treasury Management Policy Statement, Treasury Management Strategy Statement and Annual Investment Strategy. Appendix B – Provisional Counterparty List. Appendix C – Prospects for Interest Rates.
TIME REQUIRED	10 minutes.
REPORT ORIGINATOR AND CONTACT	Mark Hemming mhemming@bucksfire.gov.uk 01296 744687

Appendix A – Treasury Management Policy Statement, Treasury Management Strategy Statement and Annual Investment Strategy

Treasury Management Policy Statement

This Authority 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.

This 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, and any financial instruments entered into to manage these risks.

This 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.

The investment policy objective for this Authority is the prudent investment of its treasury balances. The Authority’s investment priorities are the security of capital and liquidity of its investments so that funds are available for expenditure when needed. Both the CIPFA Code and DCLG guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The generation of investment income to support the provision of local authority services is an important, but secondary, objective.

The Authority’s borrowing objectives are to minimise the revenue costs of debt whilst maintaining a balanced loan portfolio. The Authority will set an affordable borrowing limit each year in compliance with the Local Government Act 2003, and will have regard to the CIPFA Prudential Code for Capital Finance in Local Authorities when setting that limit.

Treasury Management Strategy Statement

Current Portfolio Position

The Authority’s treasury portfolio position as at 31 December 2013 comprised:

Borrowing

Fixed Rate Funding: £8.265m Average Rate: 4.59%

Investments

£16.738m Average Rate 1 April 2013 to 31 December 2013: 0.77%

Prospects for Interest Rates

For 2014/15, the Authority will continue with Capita (formerly known as Sector) as its external treasury management advisor. Capita's view of the prospects for interest rates can be seen in Appendix C.

Capita advise that the current benchmark rate of return on investments should be Base Rate (currently 0.50%), although the rate may be higher if the Authority is able and willing to commit funds for longer durations (up to one year). Using this benchmark figure would give an annual return of circa £84k on a balance of £16.738m (the total projected return for 2013/14 is circa £120k).

If the Annual Investment Strategy was to remain unchanged from 2013/14, the Authority projects that it could achieve an average rate of 0.55%, which would give an annual return of circa £92k on a balance of £16.738m.

By adopting the proposed revised counterparty limits within the Annual Investment Strategy (AIS) the Authority projects that it could achieve an average rate of 0.59%, which would give an annual return of circa £98k on a balance of £16.738m. Adopting the revised Strategy will also have a number of additional benefits, as detailed in 'Counterparty Limits' section of the AIS.

Borrowing Strategy

The Authority's borrowing objectives are:

- To minimise the revenue costs of debt whilst maintaining a balanced loan portfolio
- To manage the Authority's debt maturity profile, leaving no one future year with a disproportionate level of repayments

No additional borrowing is forecast to take place during the duration of the medium term financial plan.

Investment Strategy

This Authority maintains investments that are placed with reference to cash flow requirements. Investment of the Authority's funds is in accordance with the Annual Investment Strategy.

Debt Rescheduling

The potential for debt rescheduling is monitored in light of interest rate movements.

Any rescheduling will be in accordance with the borrowing strategy. The reasons for rescheduling include:

- The generation of cash savings at minimum risk
- Fulfilment of the borrowing strategy
- Enhancement of the maturity profile of the borrowing portfolio

Due to the current level of penalties on the early repayment of borrowing, it is not expected that any debt will be restructured over the medium term.

Annual Investment Strategy (AIS)

A prudent investment policy has two objectives (as defined by the DCLG guidance):

- achieving first of all security (protecting the capital sum from loss);
- and then liquidity (keeping the money readily available for expenditure when needed);
- once proper levels of security and liquidity are determined, it will then be reasonable to consider what yield can be obtained consistent with those priorities.

Investment Policy

In accordance with guidance from the DCLG and CIPFA, and in order to minimise the risk to investments, the Authority has below clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings, watches and outlooks published by all three ratings agencies with a full understanding of what these reflect in the eyes of each agency. Using the Capita ratings service potential counterparty ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

Furthermore, the Authority's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Authority will engage with its advisors to maintain a monitor on market pricing such as credit default swaps (**CDS**) and overlay that information on top of the credit ratings. This is fully integrated into the credit methodology provided by the advisors, Capita in producing its colour codings which show the varying degrees of suggested creditworthiness.

Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk.

The intention of the strategy is to provide security of investment and minimisation of risk.

Creditworthiness Policy

This Authority applies the creditworthiness service provided by Capita. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following 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.

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Authority to determine the suggested duration for investments. The Authority will therefore use counterparties within the following durational bands:

• Yellow 5 years

• Purple 2 years

• Blue 1 year (only applies to nationalised or semi nationalised UK Banks)

• Orange 1 year

• Red 6 months

• Green 3 months

• No colour not to be used

The Capita creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

Typically the minimum credit ratings criteria the Authority use will be a short term rating (Fitch or equivalents) of short term rating F1, long term rating A-, viability rating of A-, and a support rating of 1 There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored weekly. The Authority is alerted to changes to ratings of all three agencies through its use of the Capita 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 spreads 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 market information, information on government support for banks and the credit ratings of that supporting government.

The Authority will also invest in AAA rated money market funds during the year.

Country Limits

In 2013/14, the Authority determined that it would only use approved counterparties based within the United Kingdom during the year. For 2014/15, it is proposed to allow a limited number of counterparties from outside of the UK to be used. The primary purpose of this is not to increase yield, but to provide additional diversity to the portfolio to effectively manage risk. A number of non-UK banks are ranked higher than some of the UK banks on the Authority's current counterparty list. A list of the proposed counterparties is shown in Appendix B. Although Capita advise that investments can be placed with some of the counterparties for longer than 100 days, the Authority proposes to limit the duration of all non-UK investments to 100 days.

Counterparty Limits

As per the 2013/14 AIS, the Authority has determined that the maximum balance that can be invested with a single counterparty at any point in time will be no more than 30% of the portfolio, up to a limit of £5 million.

The one exception to this limit in the 2014/15 AIS will be Lloyds, where the maximum balance that can be invested will be a limit of £7.5 million. Of this £7.5 million, no more than £5 million will be invested in non-instant access (call) accounts.

The rationale for this is that Lloyds are now the Authority's main banking provider, and as part of the contract will pay credit interest on all balances at a rate of Base Rate minus 0.10% (currently giving an effective rate of 0.40%). This means that:

- A higher rate would be achieved on our main instant access account (which currently pays between 0.27% - 0.33% depending on the balance held)
- The staff time taken to move money between our main bank account and our instant access account would be reduced
- The banking charges associated with the movement of the money between the accounts would be reduced
- The additional risk exposure to the Authority would be minimal as:
    - Lloyds are part nationalised and enjoy significant support from the Government
    - All amounts over the current £5 million limit would be available for withdrawal immediately should circumstances require

Investment Security

Investments are defined as being in one of two categories:

• Specified investments – these are investments with high security and high liquidity. All specified investments are in sterling and have a maturity of no more than one year. They will be with the UK government, a local authority, a parish council or with an investment scheme or body of "high credit quality" (as judged against the Creditworthiness Policy detailed earlier in this paper)

• Non-specified investments – any type of investment that is not a specified investment. The Authority does not plan to make any non-specified investments during the year.

Investment Training

Relevant training and updates will be provided to relevant staff by the external treasury management advisors. This will be supplemented by additional training from CIPFA where necessary.

Investment of Money Borrowed in Advance of Need

The Authority does not currently have any money that has been borrowed in advance of need. No further borrowing is planned over the medium term.

Investment Liquidity

In consultation with external treasury advisors, the Authority will review its balance sheet position, level of reserves and cash requirements in order to determine the length of time for which investments can be prudently committed. Investments will be placed at a range of maturities, including having money on-call in order to maintain adequate liquidity.

Appendix B – Provisional Counterparty List

This list is based on information provided by Capita as at January 2014. Please note that all colours indicated refer to Capita's creditworthiness policy (see Appendix A):

UK Based Counterparties

Country	Counterparty	Maximum Duration
UK	Bank of New York Mellon (International) Ltd	Orange - 12 mths
UK	Barclays Bank plc – see **Note 1**	No colour - 0 mths
UK	Credit Suisse International	Red - 6 mths
UK	HSBC Bank plc	Orange - 12 mths
UK	MBNA Europe Bank	Red - 6 mths
UK	Santander UK PLC	Green - 100 days
UK	Standard Chartered Bank	Red - 6 mths
UK	Sumitomo Mitsui Banking Corporation Europe Ltd	Green - 100 days
UK	UBS Ltd	Red - 6 mths
UK	Nationwide BS	Green - 100 days
UK	Debt Management Office	Yellow - 60 mths
UK	Other Local Authorities	Yellow - 60 mths
UK*	Lloyds Banking Group Plc	Blue - 12 mths
UK*	Royal Bank of Scotland Group Plc	Blue - 12 mths

* Indicates that the counterparty is nationalised/part nationalised

The Authority will also have the ability to invest in AAA rated money market funds

Note 1 – Barclays Bank plc is currently rated by Capita at 'no colour'. This is due to the fact that the CDS rating for Barclays has moved from 'In-Range' to 'Monitoring' status when compared to the iTraxx benchmark. However this is not because the CDS rating for Barclays has risen, but because it has not fallen as fast as the benchmark. Capita expect this to be a temporary situation (possibly caused by low trading volumes over the Christmas period) and have recommended to leave the current investment of £5 million on-call, but to not place any additional fixed term deposits at present. The situation will be monitored closely over the next few weeks and months.

Non-UK Based Counterparties

Country	Counterparty	Maximum Duration (as rated by Capita)
Germany	Deutsche Bank AG	Green - 100 days
Germany	DZ BANK AG Deutsche Zentral-Genossenschaftsbank	Green - 100 days
Germany	Landesbank Berlin AG	Green - 100 days
Germany	Landesbank Hessen-Thueringen Girozentrale	Green - 100 days
Germany	Landwirtschaftliche Rentenbank	Orange - 12 mths
Sweden	Nordea Bank AB	Orange - 12 mths
Sweden	Skandinaviska Enskilda Banken AB	Red - 6 mths
Sweden	Svenska Handelsbanken AB	Orange - 12 mths
Sweden	Swedbank AB	Red - 6 mths

As noted in Appendix A, the duration of all non-UK investments will be limited to 100 days, even where Capita advise that a longer duration is acceptable.

There are a number of other non-UK based counterparties that have not been included on the list, as either the rates offered are significantly lower than available elsewhere, or that the counterparty is unlikely to take deposits of the size the Authority would be able to offer.

Counterparties Rated 'No Colour' by Capita

As noted in Appendix A, sole reliance will not be placed on the use of Capita ratings. The Authority will also use market data and market information, information on government support for banks and the credit ratings of that supporting government. The Authority proposes to add the following UK building societies rated as 'no colour' to its counterparty list. The rationale for this is:

- Building societies have an unparalleled record of investor safety. No investor (retail or wholesale) has lost money invested with a building society at least since the Second World War
- All building societies are "credit institutions" for the purposes of the EU Banking Directives, and are required to meet the same standards for capital adequacy and risk control as UK and other EU banks
- Where occasionally a society has encountered difficulties, a merger with a stronger society has ensured that both retail savers and wholesale depositors experience no uncertainty or interruption to service

The purpose of adding these additional counterparties is to improve the liquidity and cash management of the portfolio. The building societies listed below generally offer more flexibility with their fixed term deposits, allowing maturities on selected days and less than one month in duration. This will allow the Authority greater flexibility to manage ad-hoc large payments, such as retirement lump sums, which may only become known a few weeks in advance of payment.

The following building societies that the Authority proposes to use all have group assets of at least £10billion. The maximum duration for investments will be limited to 100 days.

Country	Counterparty	Maximum Duration (as rated by Capita)
UK	Coventry Building Society	No colour - 0 mths
UK	Leeds Building Society	No colour - 0 mths
UK	Skipton Building Society	No colour - 0 mths
UK	Yorkshire Building Society	No colour - 0 mths

Appendix C – Prospects for Interest Rates

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

Annual Average %	Bank Rate	PWLB Borrowing Rates (including certainty rate adjustment)		
		5 year	25 year	50 year
December 2013	0.50%	2.50	4.40	4.40
March 2014	0.50%	2.50	4.40	4.40
June 2014	0.50%	2.60	4.50	4.50
September 2014	0.50%	2.70	4.50	4.50
December 2014	0.50%	2.70	4.60	4.60
March 2015	0.50%	2.80	4.60	4.70
June 2015	0.50%	2.80	4.70	4.80
September 2015	0.50%	2.90	4.80	4.90
December 2015	0.50%	3.00	4.90	5.00
March 2016	0.50%	3.10	5.00	5.10
June 2016	0.75%	3.20	5.10	5.20
September 2016	1.00%	3.30	5.10	5.20
December 2016	1.00%	3.40	5.10	5.20
March 2017	1.25%	3.40	5.10	5.20

The following paragraphs provide Capita's commentary on the current economic situation *(due to the potentially volatile nature of the economy, this section will be updated further before presentation to the CFA).*

Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely during the remainder of 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds.

Near-term, there is some residual risk of further QE - if there is a dip in strong growth or if the MPC takes action to do more QE in order to reverse the rapid increase in market rates, especially in gilt yields and interest rates up to 10 years. This could cause shorter-dated gilt yields and PWLB rates over the next year or two to significantly undershoot the forecasts in the table below. The failure in the US, (at the time of writing), over passing a Federal budget for the new financial year starting on 1 October, and the expected tension over raising the debt ceiling in mid-October, could also see bond yields temporarily dip until any binding agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the Fed could cause bond yields to rise.

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 of bond issuance in other major western countries. Increasing investor confidence in economic recovery is also likely to compound this effect as a continuation of recovery will further encourage investors to switch back from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently weighted to the upside after five months of robust good news on the economy. However, only time will tell just how long this period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

Downside risks currently include:

- The conflict in the UK between market expectations of how quickly unemployment will fall as opposed to the Bank of England's forecasts
- Prolonged political disagreement over the US Federal Budget and raising the debt ceiling
- A return to weak economic growth in the US, UK and China causing major disappointment to investor and market expectations.
- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- The Italian political situation is frail and unstable.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds

The potential for upside risks to UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.
- Further downgrading by credit rating agencies of the creditworthiness and credit rating of UK Government debt, consequent upon repeated failure to achieve fiscal correction targets and sustained recovery of economic growth which could result in the ratio of total government debt to GDP to rise to levels that undermine investor confidence in the UK and UK debt.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- In the longer term – an earlier than currently expected reversal of QE in the UK; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.