REPORT OF:	**EXECUTIVE DIRECTOR RESOURCES AND TRANSFORMATION**
TO:	**COUNCIL**
ON:	**2nd MARCH 2015**

SUBJECT : TREASURY MANAGEMENT STRATEGY, PRUDENTIAL INDICATORS, AND MINIMUM REVENUE PROVISION POLICY 2015/16

---

1. PURPOSE OF THE REPORT

1.1 The Council is required to approve a Treasury Management Strategy before the start of each financial year. It must also set Treasury and Prudential Indicators, and a policy for a "prudent" level of Minimum Revenue Provision for repayment of debt, consistent with the Council's Medium Term Financial Strategy.

2. RECOMMENDATIONS

2.1 The Council is recommended to approve:

(a) the proposed Treasury Management Strategy for 2015/16, including Treasury Management Indicators, as outlined in Appendix 1;

(b) the proposed Prudential Indicators for 2015/16, as outlined in Appendix 2;

(c) the policy proposals for determination of Minimum Revenue Provision for repayment of debt, as outlined in Appendix 3;

(d) the investment of £50,000 in the Local Capital Finance Company, to be treated as capital expenditure, therefore increasing the capital programme, and the addition to its 2014-15 schedule of Approved Non-Specified Treasury Management Investments, of the investment of up to £100,000 in company shares where no direct service benefit arises, for the purpose of prudent management of its financial affairs

3. BACKGROUND

3.1 The Council has previously adopted CIPFA's latest *Code of Practice on Treasury Management in the Public Services* and associated Guidance Notes. The proposed Treasury Management Strategy, at Appendix 1, complies with both the CIPFA Code (2011 edition) and with current CLG guidance on Investments (issued in March 2010).

3.2 CIPFA also issues the *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code), a professional code of practice to support local authorities in taking capital investment decisions. The current requirements of the Prudential Code have been followed in determining a range of proposed Prudential Indicators for 2015/16, as outlined in Appendix 2.

4. RATIONALE

4.1 The CIPFA *Code of Practice on Treasury Management in the Public Services* requires the Council to approve a Treasury Management Strategy, including various Treasury Management Indicators, before the start of each financial year.

4.2 The Council must also set Prudential Indicators for the affordability, sustainability and prudence of its capital investment plans. These, together with the policy for setting a "prudent" level of Minimum Revenue Provision for repayment of debt, must be consistent with the Council's Medium Term Financial Strategy.

5. KEY ISSUES

5.1 Working within the regulatory and professional frameworks, the Council agrees an Annual Treasury Strategy before the start of each year. This is followed up with a mid-year Strategy Review, considered alongside the Annual Outturn Report, summarising the position for the previous financial year. The key requirements for the Council are to maintain its two investment priorities - the security of capital, and liquidity of its investments - and to seek the most cost effective way of managing its debt portfolio.

5.2 The Prudential Code provides a framework to ensure that the capital investment plans of the Council are affordable, prudent and sustainable. The prudential indicators required by the Prudential Code are designed to support and record local decision making in a manner that is publicly accountable..

6. POLICY IMPLICATIONS

The policy implications from this report are contained within the Budget Strategy.

7. FINANCIAL IMPLICATIONS

7.1 The financial implications arising from the proposed recommendations of this report with regard to 2015/16 and beyond have been incorporated into the Budget report and Council Tax recommendation to be considered by the Council.

7.2 The proposed investment of £50,000 in the Local Capital Finance Company would count as capital expenditure, most probably in 2014/15. The revenue budget implications of this decision would be for an ongoing cost of c £5,000 per annum, which can be accommodated within existing and projected revenue budgets.

There is the possibility of some future returns to the Council, either in the form of dividends or future disposal of the investment, but this would not be anticipated to arise in the short or medium term. The main benefit, which also cannot be guaranteed, is the potential to impact, directly or indirectly, on future borrowing costs, through lower interest rates.

8. LEGAL IMPLICATIONS

Under the Local Government Act 2003, local authorities determine locally their levels of capital investment and associated borrowing. The Prudential Code has been developed to support local authorities in taking these decisions, and the Council is required, under Regulation 2 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (as originally published), to have regard to the Code when carrying out its duties under Part 1 of the Local Government Act 2003.

Local authorities are required each year to set aside resources as provision for debt repayment. Previous detailed rules setting out how to calculate such a Minimum Revenue Provision (MRP) have been replaced by the requirement to make a "prudent" provision, under regulations 27 and 28 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003, as amended by the Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008.

9. RESOURCE IMPLICATIONS

None as a direct consequence of this report.

10. EQUALITY IMPLICATIONS

The decisions to be taken do not change policy and do not require any further consideration in respect of equality issues

11. CONSULTATIONS

The issues raised in this report have been discussed previously with Audit Committee and the Treasury Management Group.

Chief Officer Denise Park, Executive Director Resources & Transformation – Ext 5655

Contact Officer: Ron Turvey, Deputy Finance Manager – Ext 5303
Date: 18th February 2015

Background Papers: Draft capital programme 2015/18 and associated papers

Appendix 1

TREASURY MANAGEMENT STRATEGY 2015/16

1. Introduction

The Council has adopted successive CIPFA Treasury Management Codes, requiring the approval of a treasury management strategy before the start of each financial year.

In addition, the Department for Communities and Local Government (CLG) issued revised guidance on local authority investments, in March 2010, that requires the Council to approve an investment strategy before the start of each financial year.

This report fulfils the Council's obligations under both of these sets of guidance.

The Authority both borrows and invests substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

2. Economic Context

2.1 Economic Overview

Economic background: There is momentum in the UK economy, with a continued period of growth through domestically-driven activity and strong household consumption. There are signs that growth is becoming more balanced, with some contribution from business investment. Overall, continued, albeit slower, growth is likely. Inflationary pressure is benign and is likely to remain low in the short-term. There have been large falls in unemployment but levels of part-time working, self-employment and underemployment are significant and nominal earnings growth remains weak and below inflation.

The Monetary Policy Committee's focus is on both the degree of spare capacity in the economy and the rate at which this will be used up. Though two members voted for an increase in rates at a series of meetings, other Committee members have become more concerned at deflationary pressures.

Credit outlook: The transposition of two European Union directives into UK legislation in the coming months will place the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors. The *Bank Recovery and Resolution Directive* promotes the interests of individual and small businesses covered by the Financial Services Compensation Scheme and similar European schemes, while the recast *Deposit Guarantee Schemes Directive* includes large companies into these schemes. The combined effect of these two changes is to leave public authorities amongst only a limited range of senior creditors likely to incur losses in a failing bank after July 2015.

The continued global economic recovery has led to a general improvement in credit conditions since last year. This is evidenced by a fall in the credit default swap spreads of banks and companies around the world. However, due to the above legislative

changes, the credit risk associated with making unsecured bank deposits will increase relative to the risk of other investment options available to the Authority.

2.2 Projected Interest Rates

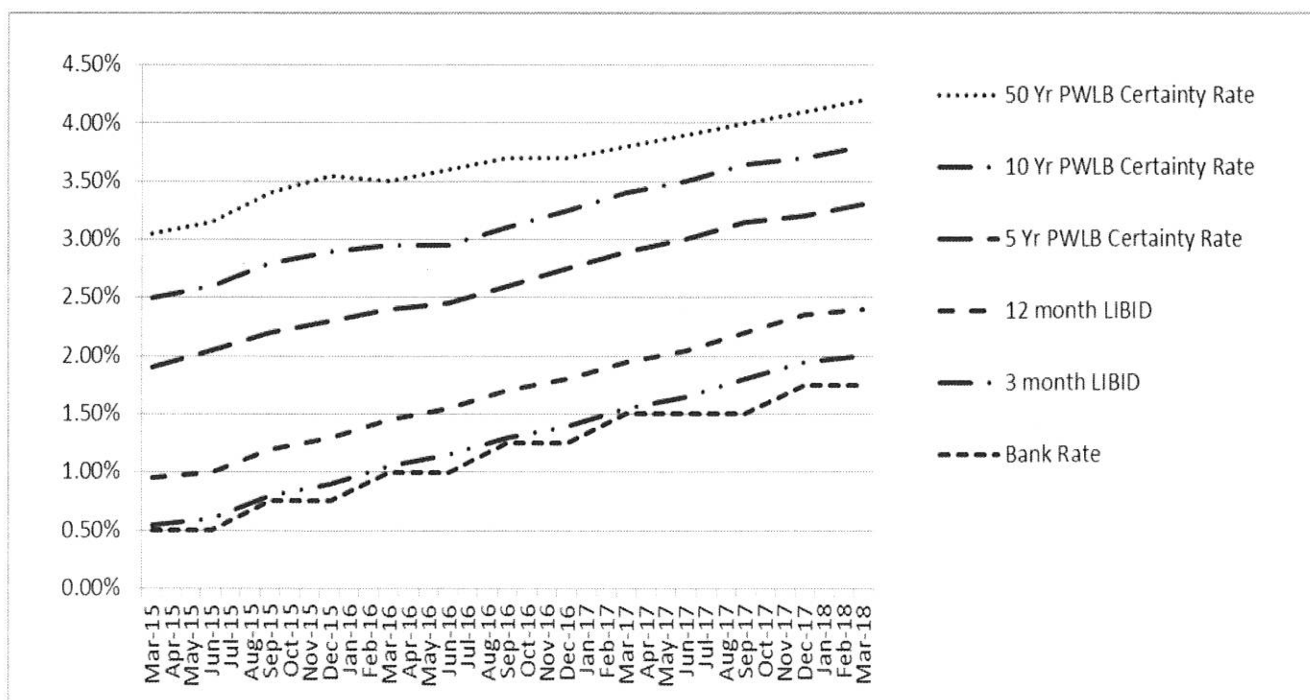
The last HM Treasury Survey of Forecasts (November 2014) showed the following range of projections for Bank Rate over the next four years:

	Average annual Bank Rate %			
	2015	2016	2017	2018
Highest	1.00	2.00	3.00	3.70
Average	0.70	1.50	2.20	2.60
Lowest	0.50	0.50	0.90	1.10

The Council's treasury adviser, Arlingclose, forecasts the first rise in official rates in August 2015, and a gradual pace of increases thereafter, with an average for 2015/16 of around 0.75%. They anticipate that the new "normalised" level of Bank Rate, post-crisis, will likely range between 2.5% and 3.5%, with risk of higher rates being greatest towards the end of the forecast horizon. A faster economic recovery would likely see rates rise more quickly. The risks of lower than projected rates have increased with continued Eurozone weakness and deflation.

Arlingclose projections for gilt yields, and hence PWLB borrowing rates, are for only limited increases in the short run, and a clearer upward path in the medium term.

Our latest forecast of interest rates is shown below.



This is a "central" view of potential rates, with significant uncertainty, and risks to both the upside and downside.

For the purpose of setting the budget for 2015/16, it has been assumed that new investments will be made at an average rate of 0.50%, and that new long-term loans will be borrowed at an average rate of over 3.50%.

3. Current and Expected Treasury Portfolios

3.1 Current Portfolio

The Council's current treasury portfolio (as at 31st December 2014) is as follows.

		Principal Amount £m	Interest Rate %
External Debt			
Borrowing by Blackburn with Darwen BC	Short term loans repayable 2014/15	14.0	0.37%
	PWLB debt maturing 2014/15	0.8	2.72%
	PWLB debt maturing 2015/16 or later	116.7	4.51%
	Market Debt maturing 2015/16 or later	23.9	5.24%
Other Long Term Liabilities	Debt managed by Lancashire County Council	17.7	2.50%
	Debt re PFI Arrangements	71.9	9.31%
Total Gross External Debt		**245.0**	**5.61%**
Investments	- maturing 2014/15	24.1	0.41%
	- maturing 2015/16	-	
	- maturing 2016/17 or later	-	
Total Investments		**24.1**	**0.41%**
Net Debt		**220.9**	**6.17%**
Net Debt excluding LCC/PFI Debt		***129.0***	**4.95%**

3.2 Expected Changes

Built into current cash flow forecasts is planned long-term borrowing of around £32 million across the remainder of 2014/15 and across 2015/16. This includes an element of "catch up" against previous under-borrowing for the capital programme, as revenue cash balances are squeezed, and allows for potential increases in the cost of borrowing. Accordingly net debt excluding LCC/PFI debt is expected to increase to over £140 million by 31st March 2015 and to over £165 million by 31st March 2016.

The decision as to when to take external borrowing will depend upon the level of cash balances available, and on current and forecast interest rates.

3.3 Budget Implications

Excluding PFI elements, largely offset by Government grant funding, the budget for debt interest payable in 2015/16 is £ 7.5 million (including the interest element of payments to LCC for debt managed on our behalf), based on an average debt portfolio of £175 million (including the LCC at £17 million) and interest rates averaging c. 4.3%. The

budget for investment income in 2015/16 is £0.1 million, based on an average investment portfolio of c. £23 million, and interest rates averaging c. 0.50%.

If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

4. Investment Strategy

4.1 Context

The Council holds significant surplus funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged from around £20 million to £65 million, mainly as a result of uneven government grant funding profiles. A wide range is also anticipated in 2015/16, though the Government is proposing a more even grant funding profile.

Both the CIPFA Code and the CLG Guidance require to Council 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 Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

4.2 Liquidity Management

The Council uses purpose-built cash flow modelling to determine the period for which funds may prudently be committed. The forecast is compiled on a cautious basis, to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Furthermore, a prudent level of funds is maintained in instant access investments, to cover most likely eventualities. Nonetheless, it is possible to borrow funds to cover short-term needs.

Long-term investments are made with due regard to the Council's medium-term cash flow forecast and financial plans.

4.3 Setting and Applying Investment Criteria

The Council's surplus cash is currently invested in short-term unsecured bank deposits and building society deposits and money market funds, along with fixed term deposits with other local authorities and the Debt Management Office (DMO). Given the increasing risk and continued low returns from short-term unsecured bank investments, the Council will consider diversifying into more secure and/or higher yielding asset classes during 2015/16.

In order to prioritise the security of investments, the Council needs to set limits as to amounts placed with different institutions and as to duration of investment. This is to maintain a diversified investment portfolio and to align amounts and durations of investments to the perceived risks associated with different counterparties.

When deteriorating financial market conditions give cause for concern, the Council will further restrict its investments to those institutions of higher credit worthiness, and reduce the duration of its investments, to seek to maintain the required level of security.

The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Authority's cash balances, then the surplus will be deposited with the UK Government, via the DMO or invested in government treasury bills for example, or with other local authorities. This may reduce the level of investment income earned, but will protect the principal sum invested.

The Council uses credit ratings from all the three main rating agencies Fitch Ratings Ltd, Moody's Investors Service Inc and Standard & Poor's Financial Services LLC to assess the risk of loss of investments. The lowest available credit rating will be used to determine credit quality. In order to make the limits straightforward to manage, limits are based on the Long-term ratings, as these ratings are those that address credit risk directly. Long-term ratings are expressed on a scale from AAA (the highest quality) through to D (indicating default). Ratings of BBB- and above are described as investment grade.

The ratings are obtained and monitored by the Council's treasury advisers, who will notify changes as they occur.

Credit ratings are a significant factor in assessing the creditworthiness of organisations. However the Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will be given to other available information on the credit quality of banks and building societies, including credit default swap prices, financial statements, information on potential government support and other market information. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the specified criteria.

Investment limits are applied at the point at which new investments are made. They are set at cautious levels, allowing for the fact that circumstances may change while investments run their course.

It is proposed that, if the investment criteria for a counterparty are no longer met, then:

- no new investments will be made,
- any existing investments that can be recalled at no cost will be recalled, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

Where a credit rating agency announces that it is actively reviewing an organisation's credit ratings with a view to downgrading it, so that it is likely to fall below the specified minimum criteria, then no further investments, other than into instant access accounts, will be made until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

The Council's investments are normally senior unsecured liabilities of the borrower, and the credit rating of the investment is therefore normally identical to the credit rating of the counterparty. However, where a credit rating agency awards a different rating to a particular class of investment instruments, the Council will base its investment decisions on the instrument credit rating rather than the counterparty credit rating.

4.4 Investment Criteria for 2015/16

4.4.1 Approved Investment Counterparties

The Council may invest its surplus funds with any of the counterparty types in the table immediately below, subject to the cash and time limits shown, AND to any other investment limits also set out in successive paragraphs below.

Approved Investment Counterparties	Specified Investments		Non-specified Investments		
	Cash limit	Time limit	Cash limit	Time Limit > I year	Time Limit 1 year +
Banks and Building Societies – Secured Deposits					
long-term credit ratings no lower than AA (or equivalent)	£5M each	364 days	£5M each	-	6 years
long-term credit ratings no lower than AA- (or equivalent)	£4M each	364 days	£4M each	-	4 years
long-term credit ratings no lower than A- (or equivalent)	£3M each	364 days	£3M each	-	2 years
long-term credit ratings no lower than BBB+ (or equivalent)	-	-	£3M each	6 months	-
long-term credit ratings of BBB or BBB- (or equivalent)	-	-	£3M each	3 months	-
Banks and Building Societies – Unsecured Deposits					
long-term credit ratings no lower than AA (or equivalent)	£5M each	9 months	£3M each	-	3 years
long-term credit ratings no lower than AA- (or equivalent)	£4M each	6 months	£2M each	-	2 years
long-term credit ratings no lower than A- (or equivalent)	£3M each	4 months	£2M each	-	18 months
long-term credit ratings no lower than BBB+ (or equivalent)	-	-	£2M each	2 months	-
long-term credit ratings no lower than BBB (or equivalent)	-	-	£2M each	next day	-
The Council's **current account banker** - provided long term credit rating no lower than BBB- (or equivalent)	-	-	£3M	next day	-
Corporates or **Registered Providers** with long-term credit ratings no lower than A- (or equivalent)	£3M each	4 months	£2M each	-	18 months
Unrated institutions, such as some building societies	-	-	£1M each	4 months	-
Company Shares where no direct service benefit arising, for the prudent management of its financial affairs - e.g. LCFC	-	-	£100,000	n/a	
Pooled funds (incl. money market funds)					
long-term credit ratings no lower than A- (or equivalent)	£5M each	n/a	-	-	-
unrated or long-term credit ratings under A- (or equivalent)	-	-	£4M each	-	n/a
UK Government	no limit	364 days	no limit	-	50 years
Other Government with long-term-credit ratings no lower than A- (or equivalent)	£5M each	364 days	£3M each	-	5 years
UK Local Authorities* (irrespective of credit rating) * as defined in the Local Government Act 2003	£5M each	364 days	£3M each	-	5 years

The maximum that will be lent to any one organisation (other than the UK Government) will be £5 million, to limit the potential loss in the case of any single counterparty failure.

The combined **Secured and Unsecured investments** made with any one counterparty will not exceed the cash limit for secured investments. Equally the combined value of **Specified and Non-specified investments** with any organisation will not exceed the highest limit for any individual class of investment set out above.

Investment in any bank that forms part of a group of banks under the same ownership will be subject to a Group Limit equal to the limit that would apply to the parent company.

4.4.2 Specified and Non-Specified Investments

Specified Investments are those expected to offer relatively high security and liquidity, and can be entered into with the minimum of formalities. The CLG Guidance defines Specified Investments as those:

- denominated in pounds sterling,
- due to be repaid within 12 months of arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
  - the UK Government,
  - a UK local authority, parish council or community council, or
  - a body or investment scheme of "high credit quality".

High Credit Quality

The definition of "high credit quality" is to be determined by each authority. This Council defines "high credit quality" organisations as those having a credit rating of A- or higher, if either domiciled in the UK ***or*** in foreign country with a sovereign rating of AA+ or higher. For money market funds and other pooled funds "high credit quality" is defined as those having a credit rating of A- or higher.

Non-specified Investments

Any investment not meeting the definition of a Specified Investment is classed as Non-specified. They will only be made in the following categories

(a) shorter term investments in bodies and schemes with low or no credit ratings – these will be closely monitored by TMG, based on advice given by the Council's treasury management advisers

(b) long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement (in higher rated counterparties)

(c) treasury investments defined as capital expenditure by legislation, such as company shares, where there is a potential for a beneficial treasury impact.

The Council does not intend to make any investments in foreign currencies.

Overall limits also apply on Non-specified Investments, as shown the table below.

Non-Specified Investments - Overall Limits	Cash limit
Total long-term investments	£7 M
Total investments without credit ratings or rated below A-	
Building Societies or Banks (subject to additional overview)	£7 M
Council's current account bank (in addition to the above)	£3 M
Pooled Funds and Money Market Funds	£15 M
Total non-specified investments	£30 M

4.4.3 Investment Limits for Foreign Countries

No country limit will apply to investments in the UK, irrespective of the UK's sovereign credit rating.

Investments in foreign countries will be limited to those that hold sovereign credit ratings of AA + or better from all three major credit rating agencies, and to a maximum of £5 million per foreign country.

The restriction on foreign investment will not apply to investment in pooled funds which may be domiciled overseas. Sovereign credit rating criteria and foreign country limits will also not apply to investments in multilateral development banks (e.g. the European Investment Bank and the World Bank).

4.4.4 Secured and Unsecured Deposits - and Current Account Bankers

Unsecured Deposits: These include accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail.

Unsecured investment with banks rated BBB or BBB- are restricted to overnight deposits at the Council's current account bank [Royal Bank of Scotland plc]. A high level of monitoring of the credit-worthiness of the current account banker will be maintained if its ratings fall this low, and this option will not be taken up if there are serious concerns. The Council is still reviewing its banking arrangements, with consideration being given as to how to best to procure banking services, going forward.

Secured Deposits: These include covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits.

4.4.5 Investment in Other Government, Corporate and Registered Providers

Other Government covers loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency.

Equivalent investments with the UK Government may be made in unlimited amounts.

Corporates covers loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent.

Registered Providers covers loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing, formerly known as Housing Associations. These bodies are tightly regulated by the Homes and Communities

Agency and, as providers of public services, they retain a high likelihood of receiving government support if needed.

4.4.6 Unrated Institutions

To allow the option to invest in the Local Capital Finance Company, and to continue to retain the option to invest in unrated building societies, it is proposed to set the limits as set out in 4.4.1 above. Both would count as Non-Specified Investments.

Equally, should Money Market Funds and other Pooled Funds (see below) be, or become unrated, investment in them would cease to qualify as Specified, and lower limits would apply to them, as Non-Specified Investments.

4.4.7 Pooled Funds (including Money Market Funds)

These include shares in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee.

Money Market Funds that offer same-day liquidity and aim for a constant net asset value will be used as an alternative to instant access bank accounts. Fees on these funds are between 0.10% and 0.20% per annum, and are deducted from the dividend paid to the Council.

There remain proposals under development which may prevent money market funds from having credit ratings. In the event that these proposals are enacted, the Council will fully review the risk position regarding future use of money market funds with its treasury adviser and act accordingly.

Pooled funds whose value changes with market prices, and/or have a notice period, will only be used for longer investment periods.

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives will be monitored regularly.

4.5 Strategy for 2015/16

Cash flow surpluses can be considered as falling into three categories -

(a) **Short-term funds** are required to meet cash flows occurring in the next month or so, and the preservation of capital and liquidity is therefore of paramount importance. Generating investment returns is of limited concern here, although it should not be ignored. Instant access AAA-rated money market funds and bank deposit accounts will be the main methods used to manage short-term cash.

(b) **Medium-term funds** which may be required in the next one to twelve months will be managed concentrating on security, with less importance attached to liquidity but a

slightly higher emphasis on yield. The majority of investments in this period will be in the form of fixed term deposits with banks and building societies. A spread of counterparties and maturity dates will be maintained to maximise the diversification of credit and interest rate risks.

(c) **Long-term funds** are not required to meet any liquidity need and can be invested with a greater emphasis on achieving higher returns. Security remains fundamental, however as any losses from defaults will impact on the total return. Liquidity is of lesser concern, although it should still be possible to sell investments, with due notice, if large cash commitments arise unexpectedly. This is where a wider range of instruments, including structured deposits, certificates of deposit, gilts and corporate bonds could be used to diversify the portfolio.

The overall Investment Strategy, therefore, will be to prioritise security of funds and maintain a mix of short-term (largely instant access) and medium-term investments to generate investment income, as market conditions permit. There are currently no long-term investments by the Council.

If there are sufficient funds at a future date, the Council will consider its options for optimising returns and making more long-term investments.

With short-term interest rates still significantly lower than long-term rates, due consideration will also be given to continuing to use surplus funds to defer making long-term borrowing or even make early repayments of long-term borrowing. In addition to the savings on the interest rate differential, this strategy will also reduce the Council's exposure to credit risk and interest rate risk.

The counterparty limits set in 4.4 (above) allow for a wider range of investment opportunities to be taken up than have previously been used by the Council. This will provide an opportunity to increase the diversification of the overall portfolio, and, in some instances, increase the security of investments made. The take up of a wider range of investment opportunities will be closely managed by TMG, following advice given by the Council's treasury management advisers.

5 Borrowing Strategy

5.1 Context and Forecast Needs

Excluding debt managed by LCC and that related to PFI arrangements, the Council currently holds c. £141 million of long-term loans, as part of its strategy for funding previous and current years' capital programmes.

Again excluding LCC/PFI elements, the Council's Capital Financing Requirement (CFR, or underlying need to borrow for capital purposes) is projected to increase (from £182 million at 31st March 2014) to £204 million at 31st March 2015, and thereafter rise to beyond £225 million by 31st March 2016, as capital expenditure is incurred.

CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. The authority expects to comply with this recommendation.

The potential new (i.e. additional) long-term borrowing requirement for 2015/16 is:

	£M
Under–borrowed against CFR to end of 13/14	39.0
Plus Projected increase in CFR in 14/15 and 15/16	43.7
Less Borrowed to date in 14/15	0.0
Plus Profiled debt repayments 14/15 and 15/16	8.5
TOTAL	**91.2**

However, depending on the pattern of interest rates during the year, it may be more cost effective to defer borrowing until later years, and to continue to keep down the size of the Council's investment balance instead.

In addition, the Council may borrow for short periods of time to cover unexpected cash flow shortages.

5.2 Sources of Borrowing

The approved sources of long-term and short-term borrowing will be:

- Public Works Loan Board (PWLB)
- any institution approved for investments above (including UK local authorities)
- any other bank or building society authorised to operate in the UK
- UK public and private sector pension funds
- capital market bond investors
- special purpose companies created to enable joint local authority bond issues, including the Local Capital Finance Company

The Council has previously raised much of its long-term borrowing from the PWLB. However other sources of finance may be available, and will also be considered.

The Authority has taken £23.5 M of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. £18.5 M of these LOBOS have options during 2015/16, and although the Authority understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Authority may take the option to repay LOBO loans at no cost if it has the opportunity to do so. It is not currently expected that the Council will take any further LOBO loans, and £2 M of the existing balance falls to be repaid in 2015/16. However in order to allow for some flexibility, the Council will limit its total exposure to LOBO loans to £28 M.

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

- leases
- Private Finance Initiative

Local Capital Finance Company was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated

source of finance than the PWLB for three reasons: borrowing authorities may be required to provide bond investors with a joint and several guarantee over the very small risk that other local authority borrowers default on their loans; there will be a lead time of several months between committing to borrow and knowing the interest rate payable; and up to 5% of the loan proceeds will be withheld from the Authority and used to bolster the Agency's capital strength instead. Any decision to borrow from the Agency will therefore be subject to a separate report to Executive Member Resources.

5.3 Strategy for 2015/16

The Authority's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Authority's long-term plans change is a secondary objective.

Given the significant cuts to public expenditure and in particular to local government funding, the Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it may be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead. This would also have the advantage of reducing overall treasury risk, as it would reduce the level of funds being invested.

However, with long-term rates forecast to rise in the coming years, any such short-term savings will need to be balanced against potential longer-term costs. The Council's treasury advisers will assist with this analysis. It may be the case that long term fixed rate borrowing will be undertaken at additional short term cost with a view to minimising future interest costs.

Long-term borrowing will therefore be undertaken if it becomes apparent that long-term interest rates may increase materially, or when the level of internal balances to "borrow" from reduces significantly.

In addition the Council may take short-term borrowing (normally for up to three months) to cover immediate cash flow requirements.

Debt Rescheduling

The Public Works Loan Board allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. The Council may take advantage of this and replace some higher rate loans with new loans at lower interest rates, or repay loans without replacement, where this is expected to lead to an overall saving or reduce risk.

6 Use of Derivatives

6.1 Derivatives

A derivative is a financial instrument whose value is derived from changes in the value of an asset or an index. Local authorities (including this Council) have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate

risk (e.g. deals agreed for future dates) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans).

Section 1 of the Localism Act 2011 included a general power competence that removes the uncertain legal position over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment). The CIPFA Code requires authorities to clearly detail their policy on the use of derivatives in the annual strategy.

The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

Derivative Counterparties

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

7 Treasury Management Indicators

The Council is asked to approve the following Treasury Management Indicators:

Adoption of CIPFA Treasury Management Code of Practice

The Council adopted the 2011 edition of the CIPFA Treasury Management Code of Practice at its March 2012 meeting.

Gross Debt and the CFR

	2015/16 £M	2016/17 £M	2017/18 £M
CFR relating to Blackburn with Darwen Borough Council capital programme	226.0	222.3	214.0

This indicator is set to ensure that the Council's external debt does not, except in the short term, exceed the total of the Capital Financing Requirement in 2014/15 plus the estimates of any additional capital financing requirement for 2015/16, 2016/17 and 2017/18. It is **not** anticipated that this will be the case.

Interest Rate Exposures
This indicator is set to control the Council's exposure to interest rate risk.

The upper limits on fixed and variable rate interest rate exposures, expressed as an amount of net principal borrowed will be:

	2015/16 £M	2016/17 £M	2017/18 £M
Upper limit on fixed interest rate exposures	229.9	226.5	218.5
Upper limit on variable interest rate exposures	43.5	48.0	46.1

Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Maturity Structure of Borrowing
This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Upper	Lower
Under 12 months	30%	0%
12 months and within 24 months	15%	0%
24 months and within 5 years	30%	0%
5 years and within 10 years	30%	0%
10 years and above	95%	25%

This indicator applies to the financial years 2015/16, 2016/17 and 2017/18. Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment. Where there is a prospect that a LOBO may be called, this has been reflected in setting these limits.

Principal Sums Invested for Periods Longer than 364 Days
The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2015/16 £M	2016/17 £M	2017/18 £M
Limit on principal invested beyond year end	7.0	5.0	3.0

The Indicators above are "standard" Treasury Management Indicators that are generally adopted by local authorities, in line with individual circumstances. These indicators have not directly addressed the key treasury priorities of Security and Liquidity, though these issues are, of course, already closely tracked throughout the year. However, working in conjunction with the Council's treasury advisers, options for the formal monitoring of performance in regard to these priorities remain under consideration.

8 Other Matters

CLG Investment Guidance also requires the Council to approve the following matters each year as part of the investment strategy:

8.1 Investment Consultants

The Council's treasury management advisers are Arlingclose Limited, who provide advice and information on the Council's investment and borrowing activities, although responsibility for final decision making remains with the Council and its officers. The services received include:

- advice and guidance on relevant policies, strategies and reports,
- advice on investment decisions,
- notification of credit ratings and changes,
- other information on credit quality,
- advice on debt management decisions,
- accounting advice,
- reports on treasury performance,
- forecasts of interest rates, and
- training courses.

The quality of this service is controlled by an annual review.

8.2 Investment Training

The needs of the Council's treasury management staff for training in investment management are assessed as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend training courses, seminars and conferences provided by our treasury advisers and CIPFA.

8.3 Investment of Money Borrowed in Advance of Need

The Council may, from time to time, borrow in advance of spending need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.

The total amount borrowed will not exceed the Authorised Limit for External Debt of £329.4 million. The maximum period between borrowing and expenditure is expected to be two years, although the Council does not link particular loans with particular items of expenditure.

9 Other Options Considered

The CLG Investment Guidance and the CIPFA Code of Practice do not prescribe any particular treasury management strategy for local authorities to adopt. The Executive Director Resources and Transformation, having consulted the Executive Member Resources, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness.

Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Reduced risk of losses from credit related defaults
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs will be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long term costs will be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs will be less certain

Appendix 2

PROPOSED PRUDENTIAL INDICATORS

1. Introduction

CIPFA, the Chartered Institute of Finance and Accountancy, issued a fully revised edition in 2011 of the *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code), which underpins the system of capital finance.

Local authorities determine their own programmes for capital investment in fixed assets that are central to the delivery of quality public services. The Prudential Code has been developed as a professional code of practice to support local authorities in taking these decisions. The Council is required by Regulation to have regard to the Prudential Code when carrying out its duties under Part 1 of the Local Government Act 2003.

2. Objectives

The framework established by the Prudential Code should support local strategic planning, local asset management planning and proper option appraisal. The objectives of the Prudential Code are to provide a framework that will ensure that the capital investment plans of the Council are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. In exceptional circumstances, the Prudential Code should provide a framework which will demonstrate that there is a danger of not ensuring the above, so that the Council can take timely remedial action.

The prudential indicators required by the Prudential Code are designed to support and record local decision making in a manner that is publicly accountable. They are not designed to be comparative performance indicators, and should be considered in parallel with the treasury management indicators required by the CIPFA *Code of Practice on Treasury Management in the Public Services.*

3. Prudential Indicators for 2015/16

Estimates of Total Capital Expenditure to be Incurred

	2015/16 £M	2016/17 £M	2017/18 £M
Blackburn with Darwen Borough Council Capital Programme	52.3	22.6	6.8
Impact on Other Long Term Liabilities of assets acquired through PFI projects	0	0	0
Prudential Indicator for Total Capital Expenditure to be Incurred	**52.3**	**22.6**	**6.8**

In later years, particularly, this may not include all projects for which additional grant finance may be approved during the year. However, grant funded spending will not affect the Council's Capital Financing Requirement.

Estimates of future Capital Financing Requirement

The Council must make reasonable estimates of the "total Capital Financing Requirement" - this is effectively the remaining debt outstanding in respect of capital expenditure, including Lancashire County Council (LCC) debt and that relating to the recognition of assets acquired under PFI projects - at the end of the next three financial years

	2015/16 £M	2016/17 £M	2017/18 £M
CFR relating to Blackburn with Darwen Borough Council capital programme	226.0	222.3	214.0
CFR relating to debt managed by LCC	16.7	16.0	15.4
CFR relating to Other Long Term Liabilities re assets acquired through PFI projects	70.1	68.6	66.8
Total Capital Financing Requirement	**312.8**	**306.9**	**296.2**

The LCC element relates to debt managed by the County Council in respect of transferred services.

The Other Long Term Liabilities in relation to PFI schemes are in respect of schools built under the Building Schools for the Future programme.

The authority's total debt over the period is projected to be lower than its highest forecast CFR.

Estimates of the Incremental Impact of Capital Investment Decisions on the Council Tax

The Council has to forecast the impact of the proposed Capital Investment decisions on Council Tax. The relevant cost of the 2015-18 capital programme proposals is:-

	2015/16 £	2016/17 £	2017/18 £
Capital financing costs	0.00	0.00	0.95
Impact on revenue running costs	0.00	0.00	0.00
Prudential Indicator for impact of investment decisions on Council Tax	**0.00**	**0.00**	**0.95**

This reflects the costs of **new** unsupported borrowing – calculated using the proposed MRP (Minimum Revenue Provision) policy – and of the associated revenue running costs of the capital programme proposals. The only new schemes financed from unsupported borrowing included in the Capital Programme proposals are "invest to save" schemes whereby any capital financing costs are forecast to be offset by savings on revenue running costs.

Estimates of Ratio of Financing Costs to Net Revenue Stream

The Council must estimate the proportion of the revenue budget taken up in financing capital expenditure.

The Net Revenue Stream is the sum of Council Tax, Business Rates and Non-Ring Fenced Central Government funding and represents the total available revenue funding which is under local control. This has already fallen significantly since 2011/12.

	2015/16 £M	**2016/17 £M**	**2017/18 £M**
Net Revenue Stream	135.2	132.2	130.2

The Indicator, below, is calculated on the basis that all of the Capital Programme, including Contingent elements, is delivered.

	2015/16	**2016/17**	**2017/18**
Main Programme capital financing costs as a proportion of Net Revenue Stream	18.14 %	19.83 %	20.73 %
BSF PFI capital financing costs as a proportion of Net Revenue Stream	5.94 %	6.08 %	6.26 %
Prudential Indicator for ratio of financing costs to Net Revenue Stream	**24.08 %**	**25.91 %**	**26.99 %**

The Council's capital financing costs in respect of BSF PFI schemes – both MRP and financing charges (interest elements) – are included, but this cost is largely covered by central government grant and does not put a pressure on Council resources.

However, at a time of severe resource constraints for the Council, the high proportion of the net revenue budget taken up in supporting the Main Programme part of the Capital Programme should be noted.

External Debt Prudential Indicators

The Council must set prudential limits for its total external debt, gross of investments, separately identifying borrowing from other long-term liabilities (i.e. Lancashire County Council debt and PFI assets completed). As well as setting an Authorised Limit for External Debt, the Council must also set an Operational Boundary for External Debt, inside the Authorised Limit, that the Council will operate within (though may *temporarily* exceed).

	Operational boundary for borrowing	**Long Term Liabilities (LCC Debt & PFI Projects)**	**Operational Boundary for External Debt**
	£M	**£M**	**£M**
2015-16	232.0	86.8	318.8
2016-17	228.4	84.5	312.9
2017-18	220.0	82.2	302.2

	Authorised limit for borrowing	**Long Term Liabilities (LCC Debt & PFI Projects)**	**Authorised Limit for External Debt**
	£M	**£M**	**£M**
2015-16	242.0	86.8	328.8
2016-17	238.4	84.5	322.9
2017-18	230.0	82.2	312.2

Appendix 3

MINIMUM REVENUE PROVISION GUIDANCE AND PROPOSED POLICY

1. Introduction

Local authorities are normally required each year to set aside some of their revenues as provision for debt repayment. Whereas there were previously detailed rules setting out how to calculate such a Minimum Revenue Provision (MRP), now, under Statutory Instrument 2008 no.414, it is required that:

"A local authority shall determine for the current financial year an amount of minimum revenue provision that it considers to be prudent."

There is not a specific definition of "prudent" provision. However, the Government issued MRP Guidance, making recommendations to authorities on the interpretation of that term. Authorities are legally obliged to "have regard" to any such guidance. A summary of the options under the Guidance is set out in Section 2, below.

Authorities have to prepare an annual statement of their policy on making MRP for submission to their full Council. This mirrors the existing requirements to report to the Council on the Prudential Borrowing Limit and Investment Policy. The aim is to give elected Members the opportunity to scrutinise the proposed use of the additional freedoms conferred under the new arrangements.

2. Guidance on Options for Prudent Provision

The Guidance offers four main options under which MRP could be made, with an overriding recommendation that the Council should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits. The requirement to 'have regard' to the guidance therefore means that: -

1. Although four main options are recommended in the guidance, there is no intention to be prescriptive by making these the only methods of charge under which a local authority may consider its MRP to be prudent.
2. It is the responsibility of each authority to decide upon the most appropriate method of making a prudent provision, after having had regard to the guidance.

Option 1: Regulatory Method
Under the previous MRP regulations, MRP was set at a uniform rate of 4% of the adjusted CFR (i.e. adjusted for "Adjustment A") on a reducing balance method (which in effect meant that MRP charges would stretch into infinity). This historic approach may be used for all capital expenditure incurred in years before the start of this new approach. It may also be used for new capital expenditure up to the amount which is deemed to be supported through the SCE annual allocation.

Option 2: Capital Financing Requirement Method
This is a variation on option 1 which is based upon a charge of 4% of the aggregate CFR without any adjustment for Adjustment A, or certain other factors which were

brought into account under the previous statutory MRP calculation. The CFR is the measure of an authority's outstanding debt liability as depicted by their balance sheet.

Option 3: Asset Life Method

This method may be applied to the debt arising from most new capital expenditure, including where desired that which may alternatively continue to be treated under options 1 or 2.

Under this option, it is intended that MRP should be spread over the estimated useful life of either an asset created, or other purpose of the expenditure. There are two useful advantages of this option: -

- Longer life assets e.g. freehold land can be charged over a longer period than would arise under options 1 and 2.
- No MRP charges need to be made until the financial year after that in which an item of capital expenditure is fully incurred and, in the case of a new asset, comes into service use (this is often referred to as being an 'MRP holiday'). This is not available under options 1 and 2.

There are two methods of calculating charges under option 3:

a. equal instalment method – equal annual instalments
b. annuity method – annual payments gradually increase during the life of the asset

Option 4: Depreciation Method

Under this option, MRP charges are to be linked to the useful life of each type of asset using the standard accounting rules for depreciation (but with some exceptions) i.e. this is a more complex approach than option 3.

The same conditions apply regarding the date of completion of the new expenditure as apply under option 3.

3. Proposed MRP Policy

The following MRP Policy is proposed, acting under Guidance issued by the Government in February 2008.

Blackburn with Darwen BC Annual MRP Policy Statement for 2015/16

The Council implemented the new Minimum Revenue Provision (MRP) Guidance in 2007/08 and has, since then, assessed the MRP it will make 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.

Within this framework, the Council proposes:

(a) for **existing capital expenditure financed from debt up to 2007/08** and all new **Government-supported borrowing arising in 2007/08 AND thereafter**, to use the Regulatory Method to determine MRP,

(b) for **capital expenditure financed from debt arising in 2007/08 AND thereafter** that is **self-financed** (i.e. not supported by the Government), to use the Asset Life Method to determine MRP,

(c) when capital expenditure financed from debt arises on major schemes, to make no MRP until the year after the asset becomes operational.

(d) in the case of finance leases and on-balance sheet PFI contracts, to set the MRP requirement at a level equal to the element of the rent/charge that goes to write down the balance sheet liability. This would have the effect of ensuring that the combined effect of MRP and finance charge for finance leases and on-balance sheet PFI schemes would equal the rent or service charge payable for the year.

(e) where loans are made to other bodies for their capital expenditure, no MRP will be charged. However, the capital receipts generated by the annual repayments on those loans will be put aside to repay debt instead.

To the extent that expenditure is not on the creation of an asset and is of a type that is subject to estimated life periods that are referred to in the Guidance, these periods will generally be adopted by the Council. However, the Council will determine useful life periods and prudent MRP in exceptional circumstances where the recommendations of the Guidance would not be appropriate.

As some types of capital expenditure incurred by the Council are not capable of being related to an individual asset, asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure.

Also, whatever type of expenditure is involved, it will be grouped together in a manner which reflects the nature of the main component of expenditure and will only be divided up in cases where there are two or more major components with substantially different useful economic lives

In the determination of MRP, the Council will be both:

(a) prudent, working within the principle that debt be repaid over a period reasonably commensurate with that over which the capital expenditure provides benefits, and

(b) practical, making detailed determinations where the impact of the calculation will be material, but taking a more general approach to the remaining unsupported debt taken on.

PROPOSAL TO INVEST £50,000 IN THE LOCAL CAPITAL FINANCE COMPANY IN 2014/15 - INCLUDING PROPOSED VARIATIONS TO 2014/15 TREASURY MANAGEMENT STRATEGY

1.0 Introduction

The LGA has taken steps to set up a municipal bond agency, the Local Capital Finance Company (LCFC), to provide a borrowing for local authorities, mainly as an alternative to the Public Works Loan Board (PWLB). The LCFC intend to raise money for local authorities on the capital market by issuing bonds. It may also arrange lending / borrowing between councils and look to source funds from other third party sources (e.g. banks, pension funds and insurance companies). The aim is to reduce borrowing costs for local authorities.

Having already attracted £2.68M investment, in "Phase 1" (from 37 councils), the LGA asked for more support (in "Phase 2") to help secure the balance of equity needed to launch the agency. They are seeking up to £10M in total and targeting £6M in this second tranche. Their guidance as to potential investment levels for medium sized authorities was in the range of £50,000 to £150,000. The minimum subscription is £10,000.

They asked for a **non-binding** letter of intent (to invest) by 4 December 2014. In order to keep this Council's option to invest open, such a letter was sent, indicating a potential investment of £50,000.

If an investment is approved, it is likely to proceed as soon as possible, and probably before the end of 2014-15.

2.0 Should we subscribe?

Equity investment in start-up companies is high risk and, viewed in isolation, far beyond our normal risk appetite. However, the sums involved are relatively small, and the potential long-term benefits of cheaper borrowing are substantial, so it may be worth giving serious consideration to the offer.

The business model proposed has been successfully used by UK housing associations and universities, and by local authorities in other countries, so it has the potential to work here too. But those ventures did not have a government run PWLB to compete with.

2.1 What are the risks involved in a share purchase?

(a) Outright loss of the investment

If the project fails, which can't be ruled out, some or all of the investment may not be returned.

(b) No return on investment –

If LCFC doesn't generate enough business to more than cover operating costs, no dividend would be payable. There are a range of reasons that could contribute to this:

- It is not certain that there are sufficient local authorities that need to borrow long-term fixed rate maturity loans, and are willing to commit in advance to borrowing at an unknown interest rate.

- The standard mechanism for issuing a tranche of bonds to the market involves those authorities participating in that tranche (i.e. looking to borrow) each issuing a joint and several guarantee over other local authorities' loans – this may dissuade some authorities from participating.

- There are other mechanisms for arranging lending between local authorities – through either brokers (typically at the shorter end of the market) or through treasury advisers.

- The PWLB/government may take steps, such as reducing the margin above gilts charged by the PWLB, which may make LCFC less competitive.

- LCFC may struggle to attract staff of sufficient calibre to operate the venture, or may find that its capacity to raise finance at sufficiently attractive prices may be damaged by market changes or other factors outside of its control.

2.2 What are the potential benefits from a share purchase?

(a) Potential dividend

If LCFC gets past likely early years losses, it could make profits in later years from the difference between interest paid to bond investors and interest received from local authority borrowers.
Some of any such profit may be retained to bolster the firm's capital base and keep interest rates low, but the remainder would be available for distribution to shareholders

(b) Possible gain from onward sale of investment

It may be possible to sell the shares at a profit at some time in the future, although there may be restrictions on future share transfers. As share ownership confers voting rights, disposal would reduce any say in how the agency would be run thereafter.

(c) Reduced borrowing costs

The largest benefit is the expected reduction in borrowing costs, at least for those authorities that have a forecast need to borrow in future. Even if the PWLB reacts by reduces rates, potentially damaging the viability of LCFC, there would be an interest cost benefit.

If LCFC could reduce future borrowing costs by 10 basis points (less than half of what it is targeting), for each £10M taken in new loans, this would give an annual ongoing saving in interest costs of £10k.

There is no way to realistically project what level of saving on borrowing costs could arise from the proposals going ahead. It is possible that parties involved in establishing the business and/or committing to a level of early borrowing could obtain preferential borrowing rates over other councils, though LCFC's ability to deliver on that would depend on the success of the enterprise.

However, LCFC loans will be available to all mainstream English authorities, not just equity investors - and any general PWLB response would likely benefit all councils - so it is difficult to characterise this as a direct benefit of purchasing shares.

On the other hand, if no-one invests, the agency will not get off the ground.

Other potential benefits should the agency go ahead are

(a) Increased diversity of borrowing options
LCFC could reduce reliance on Government lending policies, and lead to better connections and understanding between councils and potential commercial investors in the local authority infrastructure. Further types of borrowing may become available if confidence in the credit worthiness of local authorities is improved.

(b) New investment option
LCFC could give become a new option for prudent investment in local government infrastructure for councils and council pension funds

2.3.Conclusion

There would be a fair degree of risk attached to purchasing shares in LCFC, and purely from an investment point of view, it would be difficult to recommend. It is likely that some of the benefits from the LCFC going ahead could be enjoyed without participating in the early stages of its development. The issue remains whether it is worth making at least some support to the venture, as an investment in the wider range of benefits accruing.

3.0 Legal Implications

The subscription agreement requires the Council to confirm that it is a "qualified investor" and an "investment professional" as defined in financial services legislation.

The legal power to make the investment, is covered by the Local Government Act 2003 – section 12 - Power to invest :

'A local authority may invest--
(a) for any purpose relevant to its functions under any enactment, or
(b) for the purposes of the prudent management of its financial affairs.'

Under the Financial Services and Markets Act 2000 – section 86 re a "Qualified investor", refers to Section I of Annex II to the markets in financial instruments directive Directive 2004/39/EC - a

> 'Professional client is a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs. In order to be considered a professional client, the client must comply with the following criteria:
>
> ......
>
> (3) National and regional governments, public bodies that manage public debt, Central Banks, international and supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations.
> The entities mentioned above are considered to be professionals.'

In short, the Council can consider itself to meet the legal criteria required.

4.0 Amendments to the 2014-15 Treasury Management Strategy

CLG guidance on investments applies to those made under powers to invest in the Local Government Act 2003, so if as we view the proposed investment as being made under these powers, so there is a need to ensure that such investments are made under the current annual investment strategy. Also the CIPFA Treasury Management Code applies to all investments not held for service purposes,

Under the currently approved investment criteria, the Council cannot make a treasury investment in an investment defined as capital expenditure by legislation (such as company shares). In order to allow the investment to go ahead in 2014-15, it is proposed that the Council add to its schedule of Approved Non-Specified Investments, for 2014-15, the investment of up to £100,000 in company shares where no direct service benefit arises, for the purpose of prudent management of its financial affairs.

No other amendments to the existing Treasury Management Strategy are required, as the scale of the proposed investment would not impact on remaining within other limits.

5.0 Financial Implications

The proposed investment of £50,000 in the Local Capital Finance Company would count as capital expenditure, most probably in 2014/15. It is proposed that the Capital Programme be increased to allow this investment.

The revenue budget implications of this decision would be for an ongoing cost of c. £5,000 per annum, which can be accommodated within existing and projected revenue budgets.

There is the possibility of some future returns to the Council, either in the form of dividends or future disposal of the investment, but this would not be anticipated to arise in the short or medium term. The main benefit, which also cannot be guaranteed, is the potential to impact, directly or indirectly, on future borrowing costs, through lower interest rates.

6.0 Recommendation

It is recommended that the Council

(a) approve the investment of £50,000 in the Local Capital Finance Company, to be treated as capital expenditure, therefore increasing the capital programme, and

(b) approve the addition to its 2014-15 schedule of Approved Non-Specified Treasury Management Investments of the investment of up to £100,000 in company shares, where no direct service benefit arises, for the purpose of prudent management of its financial affairs.