AGENDA ITEM: 10

NORTH WALES FIRE AND RESCUE AUTHORITY

21 March 2016

Prudential Indicators, Treasury Management Strategy, Investment Strategy and Minimum Revenue Provision Policy

Report by Dawn Docx, Treasurer

PURPOSE OF REPORT

1 To present to Members the Prudential Indicators, Treasury Management Strategy, Investment Strategy and Minimum Revenue Provision (MRP) Policy for 2016/17.

2 This report was presented to the Audit Committee on the 25 January 2016 so they could review the contents before submission to the Fire Authority. Repos (Reverse Repurchase Agreements) had been added to the list of counterparties for investment purposes following advice from the Treasury Consultants. Members expressed concern over the use of Repos and would recommend that they should not be used at this time until feedback has been provided with regards their use by Conwy County Borough Council. The Audit Committee had no further observations or could find any major risks in the report and would recommend it be approved by the Authority.

INTRODUCTION

3 An interim budget report for 2016/17 was presented to Members for approval on 14 December 2015. Due to the timing of the announcement of the settlement by the Welsh Government approval of the final budget was at an extraordinary meeting of the Fire and Rescue Authority on 25 January 2016. The Prudential Indicators and Treasury Management Strategy have been prepared using the relevant data contained in the revenue and capital budgets that were approved.

4 This report shows the Prudential Indicators for 2016/17 to 2018/19 and outlines the strategy to be followed regarding borrowing and investing the Authority's funds in the financial year 2016/17. The report also sets out proposals for the Authority's policy on MRP for 2016/17. The papers attached set out:-

(i) a list of prudential indicators as required by the CIPFA Prudential Code for Capital Finance in Local Authorities (Appendix A);

(ii) the Treasury Management Strategy outlining the strategy to be followed regarding short and long-term borrowing for 2016/17 in accordance with the CIPFA ode of Practice on Treasury Management (Appendix B);

(iii) the strategy to be followed regarding the investment of Fire Authority funds (Appendix C);

(iv) Minimum Revenue Provision Statement (Appendix D).

5 The Committee should note that the strategies in the report have been prepared using guidance from the Treasury Management advisors, Arlingclose, used by Conwy County Borough Council who has the responsibility for the Fire Service Treasury function.

RECOMMENDATIONS

6 The Audit Committee is recommended to approve each of the four key elements of these reports, and recommend these to the Fire Authority :

(i) The Prudential Indicators set out in Appendix A.

(ii) The Treasury Management Strategy for 2016/17 set out in Appendix B.

(iii) The Investment Strategy at Appendix C.

(iv) The Minimum Revenue Provision Policy in Appendix D.

APPENDIX A

PRUDENTIAL INDICATORS AND CAPITAL INVESTMENT

1. INTRODUCTION

1.1 The Local Government Act 2003 requires the Authority to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected capital activity or introduces limits upon that activity, and reflects the outcome of the Authority's capital appraisal systems. This report updates currently approved indicators and introduces new indicators for 2018/19. A revised code was issued in 2009 and this report complies with the new requirements, which have asked that this report be subject to greater scrutiny by those charged with governance - for the Fire and Rescue Authority this is the Audit Committee.

1.2 The Capital Programme for 2016/17 will be presented for approval to the Fire Authority on 25 January 2016, these indicators support that programme. The Authority has freedom over capital expenditure so long as it is prudent, affordable and sustainable. In order to show it is working within these limits the Audit Committee must approve, revise and monitor at least a basic range of Prudential Indicators for the forthcoming three years.

2. THE CAPITAL EXPENDITURE PLANS

2.1 The Authority's capital expenditure plans are summarised below and this forms the first of the prudential indicators to be approved by Members. All capital expenditure in the forward programme is currently unsupported and must be funded from the Authority's own resources.

2.2 However, the Government may decide to place limits on unsupported capital expenditure by introducing a long stop control on all Local Authorities plans or, in the event of an assessment by Central Government that local plans are unaffordable at a specific Authority, it may implement a local control to limit its capital expenditure plans. No such controls were implemented during 2015/16, and it is unlikely that controls will be exercised for 2016/17.

	2014/15 Actual £'000	2015/16 Revised £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Capital expenditure	6,654	10,438	4,014	5,150	2,825
Financed by:					
Capital receipts	-22	0	-430	0	0
Capital grants	-131	0	0	0	0
Revenue	-1,234	-655	-190	0	0
Net financing need for the year	5,267	9,783	3,394	5,150	2,825

3. The Authority's Borrowing Need (the Capital Financing Requirement)

3.1 The second prudential indicator is the Authority's Capital Financing Requirement (CFR). The CFR is simply the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Authority's underlying borrowing need. The capital expenditure above which has not immediately been paid for will increase the CFR. Members are asked to approve the CFR projections as below:

	2014/15 Actual £'000	2015/16 Revised £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Capital Financing Requirement					
Opening CFR	24,320	27,444	34,871	35,577	37,901
Closing CFR	27,444	34,871	35,577	37,901	37,751
Movement in CFR	3,124	7,427	706	2,324	-150

Movement in CFR represented by					
Net financing need for the year (above)	5,266	9,783	3,394	5,150	2,825
Less MRP/VRP	-2,142	-2,356	-2,688	-2,826	-2,975
Movement in CFR	3,124	7,427	706	2,324	-150

3.2 The Authority is required to pay off an element of the accumulated General Fund capital spend each year through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake additional voluntary payments (VRP).

3.3 The expected impact of the capital expenditure decisions above on the Authority's debt and investment position are shown in the Treasury Strategy.

4. AFFORDABILITY PRUDENTIAL INDICATORS

4.1 The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Authority's overall finances. Members are asked to approve the following indicators:

4.2 **Actual and Estimates of the ratio of financing costs to net revenue stream** – This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs) against the net revenue stream. The estimates of financing costs include current commitments and the Capital Programme to be approved by members in January 2016.

	2014/15 Actual %	2015/16 Revised %	2016/17 Estimate %	2017/18 Estimate %	2018/19 Estimate %
Ratio	8.11	9.75	10.63	11.52	11.99

4.3 **Estimates of the incremental impact of capital investment decisions on the contributions from the Constituent Authorities** – This indicator identifies the revenue costs associated with the proposed three year capital programme recommended in the budget report.

	Proposed Budget 2016/17 £'000	Proposed Budget 2017/18 £'000	Proposed Budget 2018/19 £'000
Contribution Increase	50	564	1,260

APPENDIX B

<u>Treasury Management Strategy for 2016/17 -2018/19</u>

1. Introduction

1.1 The treasury management service is an important part of the overall financial management of the Authority's affairs. The prudential indicators in Appendix A consider the affordability and impact of capital expenditure decisions, and set out the Authority's overall capital framework. The treasury strategy considers the effective funding of these decisions. Together they form part of the process which ensures the Authority meets balanced budget requirement under the Local Government Finance Act 1992. There are specific treasury prudential indicators included in this strategy which require approval.

1.2 The Authority's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). The Authority adopted the CIPFA Code of Practice on Treasury Management and a Treasury Management Policy Statement on 15 December 2003. This adoption meets the requirements of the first of the Treasury Prudential Indicators. A revised policy was issued in 2011 which was approved by Members and this report is based on the new policy.

1.3 The Code requires an annual strategy to be reported to the Authority outlining the expected treasury activity for the forthcoming 3 years. A further mid-year monitoring report is produced and after the year-end a report on actual activity for the year.

1.4 A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. The strategy report will cover several areas as follows:

(i) The Authority's debt and investment projections;
(ii) The Authority's estimates and limits on future debt levels;
(ii) The expected movement in interest rates;
(iii) The Authority's borrowing strategy;
(iv) The Authority's investment, counterparty and liquidity framework;
(vi) Treasury performance indicators.

2. DEBT AND INVESTMENT PROJECTIONS 2015/16 – 2018/19

2.1 The current position as at 13 January 2016 is as follows:

Public Works Loan Board (PWLB)	- £20,499,581	Fixed Rate
Other Local Authorities	- £10,000,000	Fixed Rate

Investments - £2,100,000

2.2 The borrowing requirement comprises the expected movement in the CFR and any maturing debt which will need to be re-financed. The table below shows this effect on the treasury position over the next three years. It also highlights the expected change in investment balances.

£'000	2015/16 Revised	2016/17 Estimated	2017/18 Estimated	2018/19 Estimated
External Debt				
Debt at 1 April	24,940	32,367	33,573	36,397
Movement in CFR	7,427	706	2,324	-150
Maturing Debt Replacement	14,000	9,000	9,000	9,000
Adjustment for prior years under borrowing	0	500	500	500
Debt at 31 March	32,367	33,573	36,397	36,747
Annual change in debt	7,427	1,206	2,824	350
Investments				
Total Investments at 31 March	1,500	1,500	1,000	1,000
Investment change	0	0	-500	-500

3. LIMITS TO BORROWING ACTIVITY

3.1 Within the prudential indicators there are a number of key indicators to ensure the Authority operates its activities within well defined limits.

3.2 For the first of these the Authority needs to ensure that its total borrowing does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2016/17 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

	2015/16 Revised £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Debt at 1 April	24,940	32,367	33,573	36,397
Expected Change in Debt	7,427	1,206	2,824	350
Other Long Term Liabilities	0	0	0	0
Gross Debt at 31 March	32,367	33,573	36,397	36,747
CFR	34,871	35,577	37,900	37,751

3.3 The Treasurer reports that the Authority complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the budget report.

3.4 **The Authorised Limit** – this represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the Fire Authority. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

3.5 **The Operational Boundary** – this indicator is based on the probable external debt during the course of the year; it is not a limit. Actual external debt could vary around this boundary for short times during the year. It should act as a monitoring indicator to ensure the authorised limit is not breached.

3.6 Members are asked to approve the following authorised limit and operational boundary:

	2015/16 Revised £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Authorised Limit	36,871	37,577	39,900	39,751
Operational Boundary	34,871	35,577	37,900	37,751

4. ECONOMIC BACKGROUND AND EXPECTED MOVEMENT IN INTEREST RATES

4.1 Interest rate movement can be linked to the economic activity of the major economies and to estimate the movement in rates economists will look at current conditions and estimate future economic growth to predict the changes in rates. Given the current conditions Arlingclose believes that the longer run trend is for PWLB rates to rise slowly and the bank rate to move up by 25 basis points by September this year. The advice from our Treasury Consultants is to delay borrowing activity as long as possible and use reserves and balances to temporarily fund loan debt. However, if there is a need to borrow any new debt should be for longer than 5 years due to the current maturity profile of the debt portfolio and the need to mitigate the risk of possible interest rate changes. A brief outline of the current economic outlook and the estimated movement in interest rates is discussed below.

4.2 The UK economy had a solid 2015 with overall growth estimated to be around 2.5% through domestically-driven activity and strong household consumption. There are signs that growth is becoming more balanced. The greater contribution from business investment should support continued, albeit slower, expansion of GDP. However, 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.

4.3 In the US, the Federal Reserve raised interest rates in December 2015 to 0.5% due to continued economic gains in the labour market, household spending and improvements in the housing sector. It is implied that rates in the US will rise four times in 2016 but there will be some uncertainty in the market with the presidential elections coming up. A slowdown in the Chinese economy could affect the prospects for global growth as a whole. Changes in the Global Economy could be one of the contributing factors as to whether the Bank of England Monetary Policy Committee increase the base rate in the coming year.

4.4 The transposition of two European Union directives into UK legislation places 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 and financial organisations (including pension funds) as the only senior creditors likely to incur losses in a failing bank after July 2015.

4.5 The prediction for the change in interest rates is shown in the table below:-

	Base Rate	**5-year Gilt**	**20-year Gilt**
2016/17	1.0%	1.7%	2.6%
2017/18	1.5%	1.9%	2.7%
2018/19	1.5%	2.2%	2.8%

5. BORROWING STRATEGY 2016/17

5.1 Long-term fixed interest rates are at risk of being slightly higher over the medium term, and short term rates are expected to rise this year, though not by a great deal.

5.2 The Treasurer, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above. It is likely that shorter term fixed rates may provide lower cost opportunities in the short/medium term. However, as detailed above (paragraph 4.1) Arlingclose have advised that any new borrowing should be for longer than 5 years due to the maturity structure of the current portfolio. The cost of new borrowing at a higher rate has been factored in to the budget for 2016/17.

5.3 The PWLB has structured its lending arrangements such that debt restructuring is difficult however with the likelihood of long term rates increasing any possible debt restructuring is likely to focus on switching from longer term fixed rates to cheaper shorter term debt, although the Treasurer and treasury consultants will monitor prevailing rates for any opportunities during the year.

5.4 The option of postponing borrowing and running down investment balances will also be considered. This would reduce counterparty risk and hedge against the expected fall in investments returns. It should be appreciated that the Authority will have to borrow in the future to fund the capital programme.

6. INVESTMENT, COUNTERPARTY AND LIQUIDITY FRAMEWORK

6.1 Regulatory changes in the banking sector increases the risks associated with treasury activity. These changes, as outlined in paragraph 4.4 was fully implemented in July 2015. In light of the changes it is important that the portfolio of investments is diverse so as to spread the risk. As mentioned in paragraph 4.1 it would be prudent to use reserves and balances to temporarily fund loan debt so cash investments are kept to the minimum. It is not possible to entirely move away from investing as cash deposits to banks and building societies as some degree of liquidity is needed for cash flow purposes. It is prudent therefore to place any cash deposits short term and look at other vehicles for investing the Authority's surplus cash. To diversify the portfolio Repos (Reverse Repurchase Agreements) have been added to the list of counterparties. The current position with regards Repos will be discussed in more detail at the meeting.

6.2 The Treasurer will maintain a counterparty list in compliance with the following criteria:-

Banks £5m limit
All UK banks and their subsidiaries that have good ratings (Fitch or equivalent). This is currently defined as

long term	BBB

There have been changes to the rating agencies criteria following the change to UK banking legislation as detailed in paragraph 4.4, these changes will be reported to Members at the meeting.

Central Government £5m limit
Debt management Office

Local Authorities £2m limit
All except those subject to limitation of council tax and precepts under Part 1 of the Local Government Finance Act 1992.

Building Societies £2m limit
Building societies with a rating (as for the banking sector).

Building Societies (Assets £1bn) -£2m /9mths limit
Building societies without a rating but with assets of £1billion or more.

Reverse Repurchase Agreements - £1m limit per Repo
Lending limit for a single institution

6.3 The criteria set out above for choosing counterparties provide a sound approach to investment and are designed to reduce the financial risks to the Authority of investing money on the money market. However, the criteria listed above is for general guidance, other factors are considered as to whether a counterparty is removed from the list for example a 'Negative Watch' or changes to an institutions balance sheet leverage. The Institutions on the Counterparty list are monitored closely by the Treasury Consultants and treasury staff will adjust activities at short notice to protect the Authority's position. The controls detailed in the framework are subject to change according to the market conditions. Currently investments are only made for a maximum of 6 months as advised by our Treasury Consultants, Arlingclose. Current practice is to maintain investments for cash flow purposes only and use any surplus funds to replace borrowing.

7. TREASURY PERFORMANCE INDICATORS

7.1 There are three treasury prudential indicators the purpose of which is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs.

7.2 It is recommended that the Authority sets upper and lower limits for the maturity structure of its fixed rate borrowings as follows:

	Upper Limit	Lower Limit
Under 12 Months	55%	0%
12 Months and within 24 Months	45%	0%
24 Months and within 5yrs	45%	0%
5 yrs and within 10 yrs	75%	0%
10 yrs and above	100%	0%

The upper limit for the short term borrowing position, under 12 months, remains at 55% to enable the Authority to take advantage of the low short term interest rates. The percentage of loans maturing in under 12 months is currently 41% due to the holding of £10m of short term loans with other Local Authorities. Any new borrowing will be over a longer term as advised by our Treasury Consultants in order to spread risk.

7.3 It is recommended that the Authority approve the following limits on Fixed and Variable interest rates.

	% Borrowing
Fixed Interest Rate	55 – 100
Variable Interest Rate	0 – 35

INVESTMENT STRATEGY

1. CURRENT OUTLOOK

1.1 **Key Objectives** - The Authority's investment strategy primary objectives are safeguarding the re-payment of the principal and interest of its investments on time first and ensuring adequate liquidity second – the investment return being a third objective. Regulatory changes to the banking sector may increase the risk to the Authority as outlined in paragraph 4.4 in appendix B.

1.2 Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of the current 0.5% Base rate increasing to 0.75% by September 2016. The Authority's investment decisions are based on comparisons between the rises priced into market rates against the Authority's and advisers own forecasts.

1.3 There is a clear operational difficulty arising from the current market conditions. Ideally investments would be invested longer to secure better returns, however uncertainty over counterparties and the regulatory changes suggests shorter dated would provide better security and surplus funds be used as a substitute for borrowing.

1.4 The money available for investments is currently around £1.5m. The funds are used solely for cash flow purposes with any excess funds arising from reserves being used as a substitute for borrowing. At this time it is not foreseen that longer term investments will be made.

2. WELSH GOVERNMENT INVESTMENT GUIDANCE

2.1 The Welsh Government issued revised Investment Guidance in April 2010, and this forms the structure of the Authority's policy below.

2.2 The key intention of the Guidance is to maintain the current requirement for Authorities to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective, the guidance requires this Authority to have regard to the CIPFA publication "Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes". This Council adopted the Code on 15 December 2003 and will apply its principles to all investment activity. In accordance with the Code the Treasurer has produced its treasury management practices, TMP 1(5), covering investment counterparty policy which requires approval each year.

2.3 Annual Investment Strategy - Approved Instruments

The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of following:

(i) The strategy guidelines for decision making on investments, particularly non-specified investments.

(ii) The principles to be used to determine the maximum periods for which funds can be committed.

(iii) Specified investments the Authority will use. These are high security and high liquidity investments in sterling and with a maturity of no more than a year.

(iv) Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

2.4 The investment policy proposed for the Authority is:

(i) Strategy Guidelines –
The main strategy guidelines are outlined above with the emphasis on security and liquidity.

(ii) Investment Periods –
The Authority's policy is to lend funds for a maximum of 364 days.

(iii) Specified Investments –
These investments are sterling investments of not more than one-year maturity. These are low risk assets where the possibility of loss of principal or investment income is small. These would include investments with:

The Treasury Debt Management Office Other Local Authorities (except rate capped) All UK Banks and Building Societies with a high credit rating

(iv) Non-Specified Investments –
Non-specified investments are any other type of investment (i.e. not defined as Specified above). This includes Building Societies with no rating and lending for more than 364 days. The limit for "non-specified" investments had been set at £3m.

APPENDIX D

Minimum Revenue Provision Statement

Background

1. The Capital Financing Requirement (CFR) is simply the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources and is essentially a measure of the Authority's underlying borrowing need. The Authority is required to pay off an element of the accumulated capital spend each year through a charge to the revenue account (the MRP) although it is also allowed to undertake additional voluntary payments.

2. Regulations have been issued which require the Fire Authority to approve an MRP statement in advance of each year.

MRP Policy

3. Members are recommended to approve the following MRP policy:

   For capital expenditure incurred before 1 April 2016 and any subsequent expenditure the MRP policy will be to repay

   - 4% of the outstanding balance of capital expenditure incurred on Land & Buildings (excluding the Wrexham Fire Station new build)

   - and for Vehicles, Plant, Equipment and Infrastructure the MRP will be based on the estimated life of the assets.

   - the expenditure incurred on the new Wrexham Fire station be re-paid over the life of the lease held with the Wales Ambulance Service Trust (50 years).

4. The above policy is in line with the Regulations and also follows the practice operated by the Fire Authority for a number of years. The budget for 2016/17 approved by Members in January 2016 was set using the above practices.