APPENDIX A

TREASURY MANAGEMENT STRATEGY STATEMENT 2014/15

1. Introduction

1.1 In March 2011 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year.

1.2 In addition, the Welsh Government (WG) issued revised *Guidance on Local Authority Investments* in April 2010 that requires the Authority to approve an investment strategy before the start of each financial year.

1.3 This report fulfils the Authority's legal obligation under the *Local Government Act 2003* to have regard to both the CIPFA Code and the WG Guidance.

1.4 The Authority has borrowed and invested 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 Authority's treasury management strategy.

2. External Context

2.1 Economic background

The Bank of England's Monetary Policy Committee (MPC) through its recent forward guidance is committed to keeping policy rates low for an extended period using the Labour Force Survey unemployment rate of 7% as a threshold for when it would consider whether or not to raise interest rates, subject to certain knock-outs. Unemployment was 7.7% in August 2013, but is not forecast to fall below the threshold until 2016, due to the UK's flexible workforce.

The flow of credit to households and businesses is slowly improving but is still below pre-crisis levels. The fall in consumer price inflation from the high of 5.2% in September 2011 to 2.7% in September 2013 will allow real wage increases (i.e. after inflation) to slowly turn positive and aid consumer spending.

Stronger growth data in 2013 (0.4% in Q1, 0.7% in Q2 and 0.8% in Q3) alongside a pick-up in property prices mainly stoked by government initiatives to boost mortgage lending have led markets to price in an earlier rise in rates than warranted under Forward Guidance and the broader economic backdrop. However, with jobs growth picking up slowly, many employees working shorter hours than they would like and benefit cuts set to gather pace, growth is likely to only be gradual. Arlingclose forecasts the MPC will maintain its resolve to keep interest rates low until the recovery is convincing and sustainable.

In the US expectations for the slowing in the pace of asset purchases ('tapering') by the Federal Reserve and the end of further asset purchases will remain predominant drivers of the financial markets. The Fed did not taper in September and has talked down potential tapering in the near term. It now looks more likely to occur in early 2014 which will be supportive of bond and equity markets in the interim.

2.2 **Credit outlook**

The credit risk of banking failures has diminished, but not dissipated altogether. Regulatory changes are afoot in the UK, US and Europe to move away from the bank bail-outs of previous years to bank resolution regimes in which shareholders, bond holders and unsecured creditors are 'bailed in' to participate in any recovery process. This is already manifest in relation to holders of subordinated debt issued by the Co-op which will suffer a haircut on its conversion bail-in to alternative securities and/or equity There are also proposals for EU regulatory reforms to Money Market Funds which will, in all probability, result in these funds moving to a VNAV (variable net asset value) basis and losing their 'triple-A' credit rating wrapper. Diversification of investments between creditworthy counterparties to mitigate bail-in risk will become even more important in the light of these developments.

2.3 **Interest rate forecast**

Arlingclose's forecast is for the Bank Rate to remain flat until late 2016, the risk to the upside (i.e. rates being higher) are weighted more heavily towards the end of the forecast horizon, as the table below shows. Gilt yields are expected to rise over the forecast period with medium- and long-dated gilts expected to rise by between 0.7% and 1.1%.

2.4 A more detailed economic and interest rate forecast provided by the Authority's treasury management advisor is attached at ***Annex A***.

2.5 For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.4%, and that no new long-term loans will be required.

3. Local Context (Net borrowing position) – Not applicable to the Pension Fund

4. Borrowing Strategy – Not applicable to the Pension Fund

5. Investment Strategy

5.1 The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority's investment balance has ranged between £48 and £81 million, and similar levels are expected to be maintained in the forthcoming year. This includes the cash balances of Gwynedd Pension Fund which are pooled with the Council's funds for investment purposes. The Pension Fund requests this annually as the returns received are improved and the risks reduced by combining the cash with the Council's funds. The Pensions Committee will approve the relevant elements of this Strategy Statement and request the continuation of the pooling arrangements for 2014/15 at its meeting on 17th March 2014.

5.2 Both the CIPFA Code and the WG Guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The 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.

5.3 The Authority may invest its surplus funds with any of the counterparties in table 2 below, subject to the cash and time limits shown.

Table 2: Approved Investment Counterparties

Counterparty		**Cash limit**	**Time limit**
Banks and other organisations and securities whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:	AAA	£11m each	5 years*
	AA+		5 years*
	AA		4 years*
	AA-		3 years*
	A+		2 years
	A		1 year
	A-		
The Authority's current account bank (Barclays Bank plc) if it fails to meet the above criteria		£1m	next day
UK Central Government (irrespective of credit rating)		unlimited	10 years**
UK Local Authorities (irrespective of credit rating)		£11m each	2 years
UK Registered Providers of Social Housing whose lowest published long-term credit rating is A- or higher		£5m each	2 years
UK Building Societies without credit ratings		£1m each	1 year
Money market funds and other pooled funds		£6m each	n/a
Any other organisation, subject to an external credit assessment and specific advice from the Authority's treasury management adviser		£5m each	3 months
		£1m each	1 year
		£100k each	5 years
Business loans to local companies***		£3m each	10 years

* but no longer than 2 years in fixed-term deposits and other illiquid instruments
** but no longer than 5 years in fixed-term deposits and other illiquid instruments
*** Advancement of these loans will be approved by the procedure detailed in paragraph 5.9 below. Evaluation of the Business Loans is not part of the advice or services from the Council's treasury advisor.

5.4 There is no intention to restrict investments to bank deposits, and investments may be made with any public or private sector organisations that meet the above credit rating criteria. This reflects a lower likelihood that the UK and other governments will support failing banks as the bail-in provisions in the *Banking Reform Act 2014* and the EU *Bank Recovery and Resolution Directive* are implemented.

In addition, the Authority may invest with organisations and pooled funds without credit ratings, following an external credit assessment and advice from the Authority's treasury management adviser.

5.5 **Current Account Bank**

Following a competitive tender exercise held in 2010, the Authority's current accounts are held with Barclays Bank plc which is currently rated above the minimum A- rating in table 2. Should the credit ratings fall below A-, the Authority may continue to deposit surplus cash with Barclays Bank plc providing that investments that can be withdrawn on the next working day, and that the bank maintains a credit rating no lower than BBB- (the lowest investment grade rating).

5.6 **Registered Providers**

Formerly known as Housing Associations, Registered Providers of Social Housing are tightly regulated by the Homes and Communities Agency and retain a high likelihood of receiving government support if needed. The Authority will consider investing with unrated Registered Providers with adequate credit safeguards, subject to receiving independent advice.

5.7 **Building Societies**

The Authority takes additional comfort from the building societies' regulatory framework and insolvency regime where, in the unlikely event of a building society liquidation, the Authority's deposits would be paid out in preference to retail depositors. The Authority will therefore consider investing with unrated building societies where independent credit analysis shows them to be suitably creditworthy. The Government has announced plans to amend the building society insolvency regime alongside its plans for wide ranging banking reform, and investments in lower rated and unrated building societies will therefore be kept under continuous review.

5.8 **Money Market Funds**

These funds are pooled investment vehicles consisting of money market deposits and similar instruments. They have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager. Fees of between 0.10% and 0.20% per annum are deducted from the interest paid to the Authority. 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, while funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

5.9 Other Organisations

The Authority may also invest cash with other organisations, for example by making loans to small businesses. Because of the higher perceived risk of unrated businesses, such investments may provide considerably higher rates of return. They will however only be made following a favourable external credit assessment and on the specific advice of the Authority's treasury management adviser.

5.10 Local Loans Fund

The Council has set up a Local Loans Fund which will make loans to local businesses. These investments are included in the Non-Specific Investments table above and will be for a maximum period of 10 years. The total value of the fund for such investments is £3million. Applications for loans under this scheme will not be part of the usual credit assessment for treasury management investment purposes but will be assessed by appointed consultants and any decision to lend will be made by the Investment Panel for the scheme.

5.11 Risk Assessment and Credit Ratings

The Authority uses long-term credit ratings from the three main rating agencies Fitch Ratings, Moody's Investors Service and Standard & Poor's Financial Services to assess the risk of investment default. The lowest available counterparty credit rating will be used to determine credit quality, unless an investment-specific rating is available. Credit ratings are obtained and monitored by the Authority's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, 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 a A- rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation 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.

5.12 Other Information on the Security of Investments

The Authority understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Authority will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments 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 Debt Management Office for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

5.13 **Specified Investments**

The WG Guidance defines specified investments as those:

- denominated in pound 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".

The Authority defines "high credit quality" organisations as those having a credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher.

5.14 **Non-specified Investments**: Any investment not meeting the definition of a specified investment is classed as non-specified. The Authority does not intend to make any investments denominated in foreign currencies. Non-specified investments will therefore be limited to long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement; those that are defined as capital expenditure by legislation, such as shares in money market funds and other pooled funds; and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments are shown in table 3 below.

Table 3: Non-Specified Investment Limits

	Cash limit
Total long-term investments	£30m
Total shares in money market funds	£35m
Total investments without credit ratings or rated below [A-]	£7m
Total investments in foreign countries rated below [AA+]	£7m
Total non-specified investments	£50m

5.15 **Investment Limits**: The Authority's revenue reserves and Pension Fund cash available to cover investment losses are forecast to be £48 million on 31st March 2014. In order that no more than 23% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £11 million. A group of banks under the same ownership or a group of funds under the same management will be treated as a single organisation for limit purposes. Limits will also be placed on investments in brokers' nominee accounts *(e.g. King & Shaxson)*, foreign countries and industry sectors as below:

Table 4: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£11m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£11m per group
Any group of pooled funds under the same management	£11m per manger
Negotiable instruments held in a broker's nominee account	£11m per broker
Foreign countries	£11m per country
Registered Providers	£14m in total
Building Societies	£14m in total
Loans to small businesses	£7m in total
Money Market Funds	£35m in total

5.16 **Approved Instruments:** The Authority may lend or invest money using any of the following instruments:

- interest-bearing bank accounts,
- fixed term deposits and loans,
- callable deposits and loans where the Authority may demand repayment at any time (with or without notice),
- callable deposits and loans where the borrower may repay before maturity, but subject to a maximum of £7 million in total,
- certificates of deposit,
- bonds, notes, bills, commercial paper and other marketable instruments, and
- shares in money market funds and other pooled funds.

Investments may be made at either a fixed rate of interest, or at a variable rate linked to a market interest rate, such as LIBOR, subject to the limits on interest rate exposures below.

5.17 **Liquidity management**

The Authority uses prudent cash flow forecasting techniques to determine the maximum period for which funds may prudently be committed.

6. Treasury Management Indicators – Not applicable to the Pension Fund

7. Other Items

7.1 There are a number of additional items that the Authority is obliged by CIPFA or WG to include in its Treasury Management Strategy.

7.2 **Policy on Use of Financial Derivatives:** In the absence of any legal power to do so, the Authority will not use standalone financial derivatives (such as swaps, forwards, futures and options). Derivatives embedded into loans and investments may be used, and the risks that they present will be managed in line with the overall treasury risk management strategy.

7.3 **Investment Training:** The needs of the Authority's treasury management staff for training in investment management are assessed every year 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 Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA and other appropriate organisations.

7.4 **Investment Advisers:** The Authority has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is monitored by the Head of Finance and the Investment Manager on a regular basis.

Annex A – Arlingclose Economic & Interest Rate Forecast December 2013

Underlying assumptions:

- Growth continues to strengthen with the second estimate for Q3 growth coming in at an unrevised 0.8%. The service sector remains the main driver of growth, boosted by a contribution from construction.
- The unemployment rate has fallen to 7.6%. The pace of decline in this measure will be dependent on a slower expansion of the workforce than the acceleration in the economy, alongside the extent of productivity.
- The CPI for November has fallen to 2.1%, a much more comfortable position for the MPC. Utility price increases are expected to keep CPI above the 2% target in 2014, before falling back again.
- The principal measure in the MPC's Forward Guidance on interest rates is the Labour Force Survey (LFS) unemployment rate. The MPC intends not to raise the Bank Rate from its current level of 0.5% at least until this rate has fallen to a threshold of 7%.
- The reduction in uncertainty and easing of credit conditions have begun to unlock demand, much of which has fed through to the housing market. In response to concerns over a house price bubble, the Bank of England announced a curtailment of the Funding for Lending Scheme, which will henceforth concentrate on business lending only.
- The MPC will not hesitate to use macro prudential and regulatory tools to deal with emerging risks (such as curtailing the FLS). Absent risks to either price stability or financial stability, the MPC will only tighten policy when it is convinced about the sustained durability of economic growth.
- Federal Reserve monetary policy expectations - the slowing in the pace of asset purchases ('tapering') and the end of further asset purchases - will remain predominant drivers of the financial markets. Tapering of asset purchases will begin in Q1 2014. The US political deadlock over the debt ceiling will need resolving in Q1 2014.
- The European backstop mechanisms have lowered the risks of catastrophic meltdown. The slightly more stable economic environment at the aggregate Eurozone level could be undone by political risks and uncertainty in Italy, Spain and Portugal (doubts over longevity of their coalitions). The ECB has discussed a third LTRO, as credit conditions remain challenging for European banks.
- China data has seen an improvement, easing markets fears. Chinese leaders have signalled possible monetary policy tightening.
- On-going regulatory reform and a focus on bail-in debt restructuring of is likely to prolong banking sector deleveraging and maintain the corporate credit bottleneck.

Forecast:

- Our projected path for short term interest rates remains flat. Markets are still pricing in an earlier rise in rates than warranted under Forward Guidance and the broader economic backdrop. The MPC will not raise rates until there is a sustained period of strong growth. However, upside risks weight more heavily at the end of our forecast horizon.

- We continue to project gilt yields on an upward path through the medium term. The recent climb in yields was overdone given the soft fundamental global outlook and risks surrounding the Eurozone, China and US.

	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Official Bank Rate													
Upside risk		0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	1.00
Arlingclose Central Case	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk													
3-month LIBID rate													
Upside risk	0.20	0.25	0.30	0.35	0.40	0.50	0.55	0.60	0.65	0.70	0.75	0.90	0.95
Arlingclose Central Case	0.45	0.45	0.50	0.55	0.65	0.75	0.75	0.75	0.75	0.75	0.80	0.80	0.80
Downside risk			0.05	0.10	0.20	0.30	0.30	0.30	0.30	0.30	-0.35	-0.35	-0.35
1-yr LIBID rate													
Upside risk	0.35	0.30	0.35	0.40	0.45	0.50	0.60	0.70	0.75	0.75	0.75	0.80	0.80
Arlingclose Central Case	0.90	0.95	0.95	0.95	1.00	1.05	1.10	1.15	1.20	1.25	1.30	1.40	1.40
Downside risk	-0.25	-0.25	-0.25	-0.30	-0.35	-0.40	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
5-yr gilt yield													
Upside risk	0.50	0.75	0.75	0.75	0.85	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	1.45	1.50	1.55	1.60	1.65	1.70	1.75	1.85	1.95	2.10	2.30	2.50	2.50
Downside risk	-0.50	-0.50	-0.50	-0.50	-0.55	-0.60	-0.60	-0.60	-0.65	-0.75	-0.80	-0.80	-0.80
10-yr gilt yield													
Upside risk	0.50	0.50	0.50	0.65	0.75	0.85	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	2.55	2.60	2.65	2.70	2.75	2.80	2.85	2.90	3.00	3.10	3.30	3.50	3.50
Downside risk	-0.50	-0.50	-0.50	-0.50	-0.55	-0.60	-0.60	-0.60	-0.65	-0.75	-0.80	-0.80	-0.80
20-yr gilt yield													
Upside risk	0.50	0.75	0.75	0.75	0.85	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.25	3.30	3.35	3.40	3.45	3.50	3.55	3.65	3.75	3.85	4.05	4.15	4.15
Downside risk	-0.50	-0.50	-0.50	-0.50	-0.55	-0.60	-0.60	-0.60	-0.65	-0.70	-0.75	-0.80	-0.80
50-yr gilt yield													
Upside risk	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.45	3.50	3.55	3.60	3.65	3.70	3.75	3.80	3.85	3.95	4.05	4.15	4.15
Downside risk	-0.50	-0.50	-0.50	-0.50	-0.55	-0.60	-0.60	-0.60	-0.65	-0.70	-0.75	-0.80	-0.80