

BUSINESS SUPPORT OVERVIEW & SCRUTINY

7 FEBRUARY 2013

TREASURY MANAGEMENT STRATEGY 2013/2014

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Summary

This report seeks the scrutiny of the Council's Treasury Management Strategy for the 2013/2014 financial year. The Treasury Management Strategy incorporates within it the Treasury Management Policy Statement, Annual Investment Strategy and Minimum Revenue Provision policy.

1. Budget and Policy Framework

- 1.1 Business Support Overview and Scrutiny Committee is responsible for the scrutiny of the Council's Treasury Management, Investment Strategy and Minimum Revenue Provision Policy Statement.
- 1.2 Following scrutiny by this committee, Cabinet will consider the strategy taking into account the committee's comments.
- 1.3 Final approval of the policy and the setting of prudential indicators is a matter for Council.

2. Background

- 2.1 The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

2.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer-term cash may involve arranging long or short-term loans, or using longer-term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

2.3 The Chartered Institute of Public Finance and Accountancy (CIPFA) defines treasury management as:

“The management of the local authority’s investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.”

2.4 CIPFA's Code of Practice on Treasury Management (revised November 2011) was adopted by this Council on 24 January 2013.

2.5 The primary requirements of the code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives
- Receipt by the full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-Year Review Report and an Annual Report (stewardship report) covering activities during the previous year
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices, this has been delegated to Cabinet and for the execution and administration of treasury management decisions has been delegated to the Chief Finance Officer
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body, this has been delegated to the Business Support Overview and Scrutiny Committee.

2.6 The suggested strategy for 2013/14 in respect of the following aspects of the treasury management function is based upon the treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury adviser, Sector.

2.7 In exercising the delegations to fulfil the responsibilities set out in the Treasury Management Strategy the Council will establish a set of standards to govern the manner in which these responsibilities are exercised. These standards are referred to as the Treasury Management Practice statements and are supported by the requisite schedules that flow from the exercise of those practices. These documents were approved by Cabinet on 14 February 2012 and have been updated to reflect the amendment to treasury practices flowing from this report as well as external sources. All amendments to the practices are shown in appendix 7 to this report.

2.8 Specifically the elements that are changing are:

- Approved Countries
- Treasury and Prudential Indicators.
- The Authorised Limit and Operational Boundary for 2012/13

2.9 The strategy for 2013/14 covers:

- Capital plans and the prudential indicators
- The MRP strategy
- The current treasury position
- Treasury indicators which will limit the treasury risk and activities of the Council
- Prospects for interest rates
- The borrowing strategy
- Policy on borrowing in advance of need
- Debt rescheduling
- The investment strategy
- Creditworthiness policy
- Policy on use of external service providers.

2.10 These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the Department of Communities and Local Government (CLG) Minimum Revenue Provision (MRP) Guidance, the CIPFA Treasury Management Code and the CLG Investment Guidance.

3. The Prudential and Treasury Indicators 2013/14 – 2015/16

3.1 The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans are reflected in prudential indicators, which are designed to assist Members overview and confirm capital expenditure plans.

3.2 Capital prudential indicators are summarised within appendix 3. This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. Due to uncertainties over future funding the capital expenditure only encapsulates the capital programme currently approved supplemented by the Councils expectations in relation to grant. It is likely that these indicators will evolve as the budget setting process progresses.

- 3.3 It is a statutory duty for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the “Affordable Borrowing Limit”. In England and Wales the authorised limit represents the legislative borrowing limit.
- 3.4 The Council must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax and council rent levels is ‘acceptable’.
- 3.5 Whilst termed an “Affordable Borrowing Limit”, the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years; details of the Authorised Limit can be found in appendix 3 of this report.
- 3.6 The Authorised Limit and Operational Boundary for external borrowing within appendix 3 differentiate between external borrowing and “other long term liabilities”. Other long term liabilities are other methods the authority has used to finance capital expenditure. One of the implications of the introduction of International Financial Reporting Standards (IFRS) was that embedded leases should be recognised within the statement of accounts. Embedded leases are where the Council pays for the lease of equipment by its contractors, for example refuse collection, as these are now included within the accounts the Council also needs to include these into both the Operational Boundary and Authorised limit. Currently the embedded leases account for £3,123,000. Officers therefore propose an increase in the Operational Boundary for other long term liabilities to £4,000,000 and £4,400,000 for Authorised Limit in 2012/13 as well as 2013/14 to 2015/16.
- 3.7 The Prudential and Treasury indicators are set out in appendix 3 to this report and are relevant for the purposes of setting an integrated treasury.

4. Treasury Management Strategy

- 4.1 The capital expenditure plans set out in the prudential indicators, appendix 3, provide details of the service activity of the Council. The treasury management function ensures that the Council’s cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury/prudential indicators, the current and projected debt positions and the annual investment strategy. These are covered in detail in paragraphs 5 to 11.

5. Borrowing requirement

- 5.1 No borrowing is envisaged for the foreseeable future because of the relative position of investment returns and rates for new borrowing.

6. Prospects for Interest Rates

- 6.1 The Council has appointed Sector as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Appendix 2 draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. The following table gives the Sector central view.

Annual Average %	Bank Rate	PWLB Borrowing Rates (including certainty rate adjustment)		
		5 year	25 year	50 year
Dec 2012	0.50	1.50	3.70	3.90
March 2013	0.50	1.50	3.80	4.00
June 2013	0.50	1.50	3.80	4.00
Sept 2013	0.50	1.60	3.80	4.00
Dec 2013	0.50	1.60	3.80	4.00
March 2014	0.50	1.70	3.90	4.10
June 2014	0.50	1.70	3.90	4.10
Sept 2014	0.50	1.80	4.00	4.20
Dec 2014	0.50	2.00	4.10	4.30
March 2015	0.75	2.20	4.30	4.50
June 2015	1.00	2.30	4.40	4.60
Sept 2015	1.25	2.50	4.60	4.80
Dec 2015	1.50	2.70	4.80	5.00
March 2016	1.75	2.90	5.00	5.20

- 6.2. The economic recovery in the UK since 2008 has been the worst and slowest recovery in recent history, although the economy returned to positive growth in the third quarter of 2012. Growth prospects are weak and consumer spending, the usual driving force of recovery, is likely to remain under pressure due to consumers focusing on repayment of personal debt, inflation eroding disposable income, general malaise about the economy and employment fears.
- 6.3 The primary drivers of the UK economy are likely to remain external. 40% of UK exports go to the Eurozone, so the difficulties in this area are likely to continue to hinder UK growth. The United States (US), the main world economy, faces similar debt problems to the UK but urgently needs to resolve the fiscal cliff now that the the Presidential elections are out of the way. The resulting US fiscal tightening and continuing Eurozone problems will depress UK growth and is likely to see the UK deficit reduction plans slip.

- 6.4 This challenging and uncertain economic outlook has a several key treasury management implications:
- The Eurozone sovereign debt difficulties provide a clear indication of high counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
 - Investment returns are likely to remain relatively low during 2013/14 and beyond
 - Borrowing interest rates continue to be attractive and may remain relatively low for some time. The timing of any borrowing will need to be monitored carefully;
 - There will remain a cost of carry – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

7. Borrowing Strategy

7.1 The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement) has not been fully funded with loan debt. Cash balances derived from reserves, balances and cash flow have been used as an interim measure. This strategy is prudent as investment returns are low and counterparty risk is high and will be maintained for the borrowing.

7.2 Against this background and the risks within the economic forecast, caution will be adopted with the 2013/14 treasury operations. The Chief Finance Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- *if it was felt that there was a significant risk of a sharp FALL in long and short term rates, e.g. due to a marked increase of risks around relapse into recession or of risks of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.*
- *if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast, perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.*

8 Current Portfolio Position

8.1 The Council's treasury portfolio position at 31 March 2012, with forward projections are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

	2012/2013	2013/2014	2014/15	2015/16
	Estimate	Estimate	Estimate	Estimate
	£'000	£'000	£'000	£'000
External debt				
Debt at 1 April	182,338	172,325	162,324	162,324
Other long-term liabilities (OLTL) at 1 April	3,123	3,123	3,123	3,123
Expected change in Debt	(10,013)	(10,001)	0	0
Expected change in OLTL	0	0	0	
Actual gross debt at 31 March	175,498	165,497	165,447	165,447
The Capital Financing Requirement	252,128	249,286	246,120	244,672
Under borrowing	76,630	83,789	80,673	79,225

- 8.2 The general aim of this Treasury Management Strategy is to continue to reduce the gross debt levels of the authority as and when it is prudent and economically viable to do so, due to the relationship between borrowing and investment interest rates and in order to reduce the credit risk incurred by holding investments. This policy has already been applied for a number of years resulting in a substantial reduction in credit risk and revenue interest costs.
- 8.3 2013/14 is expected to see a continuance of historically very low bank rates and supports the continued strategy to resist borrowing and reduce cash balances as over the next three years, investment rates are expected to be below long-term borrowing rates. Value for money considerations would indicate that best value is obtained by avoiding new external borrowing and by using internal cash balances to finance new capital expenditure or to replace maturing external debt (this is referred to as internal borrowing). This would maximise short-term savings.
- 8.4 However, short term savings by avoiding new long-term external borrowing must also be weighed against the potential for incurring additional long term extra costs by delaying unavoidable new external borrowing until later years when Public Works Loans Board (PWLB) long term rates are forecast to be significantly higher.
- 8.5 The Council has examined the potential for undertaking early repayment of some external debt to the PWLB in order to reduce size of the external debt position. However, the introduction by the PWLB of significantly lower repayment rates than new borrowing rates in November 2007, which has now been compounded since October 2010 by a considerable further widening of the difference between new borrowing and repayment rates, has meant that large premiums would be incurred by such action and would also do so in the near term; such levels of premiums cannot be justified on value for money grounds. This situation will be monitored in case these differentials are narrowed by the PWLB at some future date.

- 8.6 Against this background caution will be adopted with the 2013/14 treasury operations. The Chief Finance Officer will monitor the interest rate market and adopt a pragmatic approach to changing circumstances with decisions reported within the reviews of this strategy.
- 8.7 Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the Capital Financing Requirement (CFR) in the preceding year plus the estimates of any additional CFR for 2013/14 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. This is a minor change from previous years whereby this indicator measured the CFR against net debt rather than gross.
- 8.8 The Chief Finance Officer reports that the Council 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 this budget report.

9 Policy on Borrowing in Advance of Need

- 9.1 The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.
- 9.2 Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

10. Debt Rescheduling

- 10.1 As short-term borrowing rates will be considerably cheaper than longer-term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).
- 10.2 The reasons for any rescheduling to take place will include:
- the generation of cash savings and / or discounted cash flow savings
 - helping to fulfil the treasury strategy
 - enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

- 10.3 Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.
- 10.4 Decisions related to rescheduling will similarly be reported in reviews of this strategy.

11. Annual Investment Strategy

11.1 Investment Policy

- 11.1.1 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, and lastly the return on investment.
- 11.1.2 In accordance with guidance from CLG and CIPFA, and in order to minimise the risk to investments, the Council has below clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings, watches and outlooks published by all three ratings agencies with a full understanding of what these reflect in the eyes of each agency. Using the Sector ratings service potential counterparty ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.
- 11.1.3 Further, the Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as "Credit Default Swaps" and overlay that information on top of the credit ratings. This is fully integrated into, the credit methodology provided by the advisors, Sector in producing its colour codings, which show the varying degrees of suggested creditworthiness.
- 11.1.4 Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.
- 11.1.5 The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk.

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

11.1.7 Investment instruments identified for use in the financial year are listed in appendix 5 under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

11.2 Creditworthiness policy

11.2.1 This Council applies the creditworthiness service provided by Sector. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moodys and Standard and Poors. The credit ratings of counterparties are supplemented with the following overlays:

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

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

- Yellow - 5 years
- Purple - 2 years
- Blue - 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange - 1 year
- Red - 6 months
- Green - 3 months
- No Colour - not to be used

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

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

11.2.5 All credit ratings will be monitored primarily via Sector updates by officers on a continuous basis. The Council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service.

- If a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- In addition to the use of credit ratings, the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

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

11.2.7 Investec use the following methodology to compile its counterparty list.

11.2.8 Three key elements are continuously addressed.

- (a) Ratings set by Standard and Poors and Fitch IBCA
- (b) Credit Default Swap levels (CDS's)
- (c) Subjective Overlay.

11.2.9 The Fund Managers "score" the markets current attitude to our counterparties on the standard lending list.

11.2.10 Scores are given for the following three important tests:

- Will a bank buy back its own certificates of deposits (CDs) from us? If the answer is "Yes" this is seen as a signal that there is satisfactory liquidity and a low score will result. A "No" will lead to a high score to reflect the more restricted liquidity and the need to use the secondary market in order to dispose of a holding.
- Is the bank a frequent or rare issuer of CDs? Frequent issuers are likely to be less attractive in the secondary market (e.g. investment houses "may be full of the name" or the issuing bank may be viewed as having an above average need for new funding). Rare issuers will be more highly regarded.
- Do CDs issued by the banks trade "well" in the secondary market? The market's appetite for CDs is seen as a signal about credit concerns or otherwise for any bank.

11.3 Counterparty Limits

12.3.1 The current counterparty limits are set as:

- in-house team £20 million limit per counterparty and £25 million for counterparties with a Sector duration rating of 12 months or above
- 20% of the managed portfolio for the fund manager.

11.3.2 No amendments are requested to these counterparty limits.

11.4 Country limits

11.4.1 The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch (or equivalent), with the exception of United Kingdom, where there will be no restriction on the sovereign credit rating. The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 6. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

11.4.2 The country limit is reinforced by the application of a financial limit to investment such that a maximum of £40 million may be invested in any one country save the United Kingdom where no limit is imposed.

11.5 Investment Strategy

11.5.1 In-house funds.

Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

11.5.2 Investment returns expectations.

Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 4 of 2014. Bank Rate forecasts for financial year ends (March) are:

- 2012/13 0.50%
- 2013/14 0.50%
- 2014/15 0.75%
- 2015/16 1.75%.

11.5.3 There are downside risks to these forecasts (i.e. start of increases in Bank Rate is delayed even further) if economic growth remains weaker for longer than expected. However, should the pace of growth pick up more sharply than expected there could be upside risk, particularly if Bank of England inflation forecasts for two years ahead exceed the Bank of England's 2% target rate.

11.5.4 The suggested budgeted investment earnings rates for returns on investments placed for periods up to three months during each financial year for the next three years are as follows:

2013/14	0.50%
2014/15	0.60%
2015/16	1.50%

11.6 End of year investment report

11.6.1 At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

11.7 External Fund Managers

11.7.1 £23 million of the Council's funds are externally managed on a discretionary basis by Investec Asset Management.

11.7.2 Investec Asset Management will comply with the Annual Investment Strategy. The agreement between the Council and Investec additionally stipulate guidelines and duration and other limits in order to contain and control risk.

11.7.3 Investec apply their own credit criteria to investments but only after they have met a minimum criteria set this authority, the table below sets out this minimum criteria.

	Proposed criteria Fitch
Long term	A
Short term	F1
Individual / financial strength	C
Support	1

12. **Policy on the use of external service providers**

12.1 The Council uses Sector as its external treasury management advisors.

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

12.3 It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

13. Kent County Council (KCC) Local Government Reorganisation (LGR) Debt

- 13.1 The charge for the share of KCC debt for which Medway Council was responsible on local government reorganisation is based on the current average cost of debt for the County Council as a whole. KCC rates had been decreasing year-on-year as the county took on cheaper new debt but this has recently marginally reversed with the loss of beneficial rates for short-term as they are repaid. Whilst the county rate at a projected 5.44% remains marginally higher than Medway's own average debt rate of 4.15% for 2012/13, the margin between Public Works Loans Board (PWLB) debt rates for new borrowing and restructured debt (currently 4.24% versus 3.10% for 25 year borrowing) is such that this saving would be negated by the penalty involved. The outstanding principal at 1 April 2013 will be £43.5 million.

Current and Historical Rates of Interest Charged on KCC LGR debt

Year	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
	Actual	Actual	Actual	Actual	Actual	Estimate	Estimate
Rate	5.74%	5.51%	5.08%	5.21%	5.30%	5.44%	5.51%

14 Minimum Revenue Provision (MRP)

- 14.1 The Minimum Revenue Provision is explained and the Policy Statement for 2013/14 is set out at Appendix 1. The MRP calculation continues to be reviewed by officers, in order to apply the most financially advantageous and yet prudent approach to MRP. The introduction of the Housing Revenue Account (HRA) self-financing regime leaves it open for authorities to determine an MRP for the HRA but there is no necessity for making such a provision.

15 Risk management

- 15.1 As stated within the Treasury Strategy, a key driver for the review of the CIPFA code has been the exposure to risk evidenced by the Icelandic investments and more generally by the financial crisis. Risk and the management thereof is a feature throughout the strategy and in detail within the Treasury Management Practices 1 within the Treasury Strategy.

16. Diversity Impact Assessment

- 17.1 The Treasury Management Strategy does not directly impact on members of the public as it deals with the management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. Decisions are based upon the principles highlighted within the strategy and have no impact on any one particular group.

17. Financial and legal implications

17.1 The finance and legal positions are set out throughout the main body of the report.

18. Recommendations

18.1 The committee is requested to forward its endorsement and any comments of the draft Treasury Management Strategy to Cabinet on 12 February 2013.

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Background papers

Investec reports

Sector reports

APPENDIX 1

Minimum Revenue Provision Policy Statement 2013/14

The Council implemented the new Minimum Revenue Provision (MRP) guidance in 2007/2008, and assessed MRP for 2007/2008 onwards 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.

In setting the Minimum Revenue Provision Policy, Medway Council has regard to the guidance and will set a policy to ensure a prudent provision for the repayment of debt.

The major proportion of the MRP for 2013/14 will relate to the more historic debt liability that will continue to be charged at the rate of 4%, in accordance with option 1 of the guidance.

Certain expenditure reflected within the debt liability at 31 March 2013 will, under delegated powers be subject to MRP under option 3, which will be charged over a period which is reasonably commensurate with the estimated useful life applicable to the nature of expenditure, using the equal annual instalment method (or annuity method if appropriate). For example, capital expenditure on a new building, or on the refurbishment or enhancement of a building, will be related to the estimated life of that building.

The Council will treat all expenditures as not ranking for MRP until the year after the scheme or asset to which they relate is completed and/or brought into use, rather than confine this approach solely to expenditures treated for MRP purposes under Option 3

Estimated life periods will be determined under delegated powers. 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 reserves the right to 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 case of long term debtors arising from loans or other types of capital expenditure made by the Council which will be repaid under separate arrangements (such as long term investments), or where borrowing has occurred but will be repaid by future Capital Receipts or agreed income from other source, there will be no Minimum Revenue Provision made.

There is no requirement on the HRA to make a minimum revenue provision.

APPENDIX 2

Interest Rate Forecasts 2013 – 2016

Sector's Interest Rate View														
	Now	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
3 Month LIBID	0.39%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.60%	0.60%	0.70%	0.80%	1.10%	1.40%	1.70%
6 Month LIBID	0.54%	0.70%	0.70%	0.70%	0.70%	0.70%	0.70%	0.80%	0.90%	1.00%	1.10%	1.30%	1.60%	1.90%
12 Month LIBID	0.88%	1.00%	1.00%	1.00%	1.00%	1.00%	1.10%	1.10%	1.20%	1.30%	1.30%	1.50%	1.80%	2.10%
5yr PW LB Rate	1.85%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
10yr PW LB Rate	2.87%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
25yr PW LB Rate	4.02%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
50yr PW LB Rate	4.15%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
Bank Rate														
Sector's View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
UBS	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
Capital Economics	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
5yr PW LB Rate														
Sector's View	1.85%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
UBS	1.85%	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	1.85%	1.55%	1.30%	1.30%	1.30%	1.30%	1.30%	1.50%	1.60%	-	-	-	-	-
10yr PW LB Rate														
Sector's View	2.87%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
UBS	2.87%	3.00%	3.10%	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	-	-	-	-	-
Capital Economics	2.87%	2.55%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	-	-	-	-	-
25yr PW LB Rate														
Sector's View	4.02%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
UBS	4.02%	4.20%	4.30%	4.40%	4.50%	4.50%	4.50%	4.50%	4.50%	-	-	-	-	-
Capital Economics	4.02%	3.70%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	-	-	-	-	-
50yr PW LB Rate														
Sector's View	4.15%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
UBS	4.15%	4.30%	4.40%	4.50%	4.60%	4.60%	4.60%	4.60%	4.60%	-	-	-	-	-
Capital Economics	4.15%	4.00%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	-	-	-	-	-

APPENDIX 3

Prudential and Treasury Indicators

PRUDENTIAL INDICATORS	2013/2014	2014/2015	2015/2016
Extract from budget and rent setting report	estimate	estimate	estimate
	£'000	£'000	£'000
Capital Expenditure			
Non - HRA	27,566	4,561	750
HRA	5,000	5,000	5,000
TOTAL	32,566	9,561	5,750
Ratio of financing costs to net revenue stream			
Non - HRA	2.99%	2.83%	2.85%
HRA	17.94%	18.43%	17.78%
Gross borrowing requirement			
brought forward 1 April	172,325	162,224	162,224
carried forward 31 March	162,224	162,224	162,224
in year borrowing requirement	(10,001)	0	0
Capital Financing Requirement as at 31 March			
Non – HRA	209,770	207,404	206,721
HRA	39,516	38,726	37,951
TOTAL	249,286	246,120	244,672
Annual change in Cap. Financing Requirement			
Non – HRA	(2,035)	(2,376)	(673)
HRA	(806)	(790)	(775)
TOTAL	(2,841)	(3,167)	(1,448)
Incremental impact of capital investment decisions	£ p	£ p	£ p
Increase in council tax (band D) per annum	3.87	(7.54)	0.60
Increase in average housing rent per week	0.46	0.92	(0.10)

TREASURY MANAGEMENT INDICATORS	2013/2014	2014/2015	2015/2016
	estimate	estimate	estimate
	£'000	£'000	£'000
Authorised Limit for external debt -			
Borrowing	431,515	425,832	422,039
other long term liabilities	4,400	4,400	4,400
TOTAL	435,915	430,232	426,439
Operational Boundary for external debt -			
borrowing	392,286	387,120	383,672
other long term liabilities	4,000	4,000	4,000
TOTAL	396,286	391,120	387,672
Actual external debt	165,497	165,447	165,447
HRA Maximum CFR Debt Limit	45,846	45,846	45,846
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / investments	100%	100%	100%
Upper limit for variable rate exposure			
Net principal re variable rate borrowing / investments	40%	40%	40%
Upper limit for total principal sums invested for over 364 days (per maturity date)	£150,000	£150,000	£150,000

TABLE 5: Maturity structure of fixed rate borrowing during 2011/2012	upper limit	lower limit
under 12 months	50%	0%
12 months and within 24 months	50%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	50%	0%
10 years and above	100%	0%

The Global economy

The Eurozone debt crisis has continued to cast a pall over the world economy and has depressed growth in most countries. This has impacted the UK economy which is unlikely to have grown significantly in 2012 and is creating a major headwind for recovery in 2013. Quarter 2 of 2012 was the third quarter of contraction in the economy; this recession is the worst and slowest recovery of any of the five recessions since 1930. A return to growth of 0.9% in quarter 3 is unlikely to prove anything more than a washing out of the dip in the previous quarter before a probable return to negative growth in quarter 4; this would leave overall growth in 2012 close to zero and could then lead into negative growth in quarter 1 of 2013, which would then mean that the UK was in its first triple dip recession since records began in 1955.

The **Eurozone sovereign debt crisis** abated following the European Central Bank's (ECB) commitment to a programme of Outright Monetary Transactions i.e. a pledge to buy unlimited amounts of bonds of countries which ask for a bailout. The immediate target for this statement was Spain which continues to prevaricate on making such a request, (for a national bailout), and so surrendering its national sovereignty to International Monetary Fund (IMF) supervision. However, the crisis in Greece has subsided, for the time being, as a result of the Eurozone agreement to provide a further €50 billion financial support package in December. Many commentators, though, still view a Greek exit from the Euro as being likely in the longer term as successive rounds of austerity packages could make it more difficult to bring down the annual deficit and total debt as ratios of Gross Domestic Product (GDP) due to the effect they have on shrinking the economy and reducing employment and tax revenues. However, another possible way out would be a major write down of total Greek debt; this has now been raised by the German Chancellor as a possible course of action, but not until 2014-15, and provided the Greek annual budget is in balance.

Sentiment in financial markets has improved considerably since this ECB action and additional financial support for Greece to ensure that the Eurozone remained intact during 2012. However, the foundations to this "solution" to the Eurozone debt crisis are still weak and do not address the huge obstacle of unemployment rates of over 25% in Greece and Spain. It is also possible that the situations in Portugal and Cyprus could deteriorate further in 2013 and, although they are minor economies, such developments could unnerve financial markets. There are also general elections coming up in Italy and Germany which could potentially produce some upsets on the political scene. It is, therefore, quite possible that sentiment in financial markets could turn during 2013 after the initial burst of optimism at the start of the year. While equity prices have enjoyed a strong start to 2013, the foundations for this stock market recovery are shallow given the economic fundamentals in western economies. In addition, quantitative easing (QE) has to come to an end at some point in time and there is a distinct increase in doubt in the central banks of the US and UK as to the effectiveness of any further QE in stimulating economic growth. An end to central purchases of bonds may lead to a fall in bond prices.

The US economy has only been able to manage weak growth in 2012 despite huge efforts by the Federal Reserve to stimulate the economy by liberal amounts of quantitative easing combined with a commitment to a continuation of ultra low interest rates into 2015. Unemployment levels have been slowly reducing but against a background of a fall in the numbers of those available for work. The fiscal cliff facing the President at the start of 2013 has been a major dampener discouraging business from spending on investment and increasing employment more significantly in case there is a sharp contraction in the economy in the pipeline. The fiscal cliff, and raising the total debt ceiling, still await final resolution by the end of February. The housing market, though, does look as if it has, at long last, reached the bottom and house prices are now on the up.

Hopes for a broad based recovery have, therefore, focused on the **emerging markets**. Recent news from China appears to indicate that the economy has returned to a healthier rate of growth. However, there are still concerns around the unbalanced nature of the economy which is heavily dependent on new investment expenditure. The potential for the bubble in the property sector to burst, as it did in Japan in the 1990s, could have a material impact on the economy as a whole.

The UK economy

The Government's austerity measures, aimed at getting the public sector deficit into order, have now had to be extended, in the autumn statement, over a longer period than the original four years. Achieving this new extended timeframe will still be dependent on the UK economy returning to a reasonable pace of growth towards the end of this period.

Currently, the UK is enjoying a major financial benefit from some of the lowest sovereign borrowing costs in the world as the UK is seen as a safe haven from Eurozone debt. However, the subsiding of market concerns over the Eurozone has unwound some of the attractiveness of gilts as a safe haven and led to a significant rise in gilt yields. There is little evidence that UK consumer confidence levels are recovering, nor that the manufacturing sector is picking up. The dominant services sector disappointed in December with the Purchase Managers Index (PMI) survey indicating the first fall in activity in two years. On the positive side, banks have made huge progress since 2008 in shrinking their balance sheets to more manageable levels and also in reducing their dependency on wholesale funding. However, availability of credit remains tight in the economy and the Funding for Lending scheme, which started in August 2012, has not yet had time to make a significant impact in respect of materially increasing overall borrowing in the economy. Finally, the housing market remains tepid and the outlook is for house prices to be little changed for a prolonged period.

Economic Growth. Economic growth has basically flat lined since the election of 2010 and, worryingly, the economic forecasts for 2012 and beyond were revised substantially lower in the Bank of England Inflation quarterly report for August 2012 and were then further lowered in the November Report. Quantitative Easing (QE)

increased by £50 billion in July 2012 to a total of £375 billion. Many forecasters are expecting the Monetary Policy Committee (MPC) to vote for a further round of QE in early 2013 to try to stimulate economic activity. The announcement in November 2012 that £35 billion will be transferred from the Bank of England's Asset Purchase Facility to the Treasury (representing coupon payments to the Bank by the Treasury on gilts held by the Bank) was also effectively a further addition of QE.

Unemployment. The Government's austerity strategy has resulted in a substantial reduction in employment in the public sector. Despite this, total employment has increased to the highest level for four years as over one million jobs have been created in the private sector in the last two years.

Inflation and Bank Rate. Inflation has fallen sharply during 2012 from a peak of 5.2% in September 2011 to 2.2% in September 2012. However, inflation increased back to 2.7% by the end of the year, though it is expected to fall back to reach the 2% target level within the two year horizon.

AAA rating. The UK continues to enjoy an AAA sovereign rating. However, the three main credit rating agencies have stated that they will be reviewing this rating in early 2013; they will, thereafter, also be carefully monitoring the rate of growth in the economy as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years.

Sector's forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains relatively fragile and whilst there is still a broad range of views as to potential performance, expectations have all been downgraded during 2012. Key areas of uncertainty include:

- the potential for the Eurozone to withdraw support for Greece at some point if the Greek government was unable to eliminate the annual budget deficit and the costs of further support were to be viewed as being prohibitive, so causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself. The same considerations could also apply to Spain;
- inter-government agreement on how to deal with the overall Eurozone debt crisis could fragment;
- the impact of the Eurozone crisis on financial markets and the banking sector;
- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to manufactured goods;
- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that are unlikely to be achieved;
- the risk of the UK's main trading partners, in particular the EU and US, falling into recession;

- stimulus packages failing to stimulate growth;
- elections due in Italy and Germany in 2013;
- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China;
- the potential for action to curtail the Iranian nuclear programme;
- the situation in Syria deteriorating and impacting other countries in the Middle East.

The focus of so many consumers, corporates and banks on reducing their borrowings, rather than spending, will continue to act as a major headwind to a return to robust growth in western economies.

Given the weak outlook for economic growth, Sector sees the prospects for any changes in Bank Rate before 2015 as very limited. There is potential for the start of bank rate increases to be even further delayed if growth disappoints. Sector believes that the longer run trend is for gilt yields and Public Works Loans Board (PWLB) rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. The interest rate forecast in this report represents a balance of downside and upside risks. The downside risks have already been commented on. However, there are specific identifiable upside risks as follows to PWLB rates and gilt yields, and especially to longer term rates and yields:-

- UK inflation being significantly higher than in the wider EU and US causing an increase in the inflation premium in gilt yields;
- Reversal of QE; this could initially be allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held;
- Reversal of sterling's safe haven status on an improvement in financial stresses in the Eurozone;
- Investors reverse de-risking by moving money from government bonds into shares in anticipation of a return to worldwide economic growth;
- The possibility of a UK credit rating downgrade.

Specified and Non-Specified Investments

SPECIFIED INVESTMENTS:

(All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' rating criteria where applicable)

	* Minimum 'High' Credit Criteria	Use
Debt Management Agency Deposit Facility	--	In-house and Fund Manager
Term deposits – local authorities	--	In-house and Fund Manager
Term deposits – banks and building societies	See note 1 and 2	In-house and Fund Manager
Collateralised deposit (see note 3)	UK sovereign rating	In-house and Fund Manager
Certificates of deposit issued by banks and building societies	See note 1 and 2	In-house and Fund Manager
UK Government Gilts	UK sovereign rating	In-house buy and hold and Fund Manager
Bonds issued by multilateral development banks	AAA	In-house buy and hold and Fund Manager
Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government (refers solely to GEFCO - Guaranteed Export Finance Corporation)	UK sovereign rating	In-house buy and hold and Fund Manager
Sovereign bond issues (other than the UK govt)	AAA	In-house buy and hold and Fund Manager
Treasury Bills	UK sovereign rating	In house and Fund Manager
Government Liquidity Funds	* Long-term AAA volatility rating V1+	In-house and Fund Managers
Money Market Funds	* Long-term AAA volatility rating V1+	In-house and Fund Managers

Note 1. Award of "Creditworthiness" Colour by Sector Treasury services as detailed in paragraph 11.2

Note 2. Inclusion within the Investec approved Counterparty list as detailed in paragraph 11.2

Accounting treatment of investments. The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, officers will review the accounting implications of new transactions before they are undertaken.

NON-SPECIFIED INVESTMENTS: These are any investments which do not meet the Specified Investment criteria. A maximum of 70% ** will be held in aggregate in non-specified investment

1. Maturities of ANY period

	* Minimum Credit Criteria	Use	** Max % of total investments	Max. maturity period
Fixed term deposits with variable rate and variable maturities: -Structured deposits	See note 1	In-house	£10m	Lower of 5 years or Sector duration rating

2. Maturities in excess of 1 year

	* Minimum Credit Criteria	Use	** Max % of total investments	Max. maturity period
Term deposits – local authorities	--	In-house	40%	5 Years
Term deposits – banks and building societies	See note 1	In-house	40%	As per Sector duration rating
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	See note 1 and 2	In-house and Fund manager	40%	As per Sector duration rating and see note 3
Certificates of deposit issued by banks and building societies	See note 1 and 2	In-house and Fund manager	40%	As per Sector duration rating and see note 3
UK Government Gilts	UK sovereign rating	In-house and Fund Manager	40% In-house 100% Investec	In-house see note 1, Investec see note 2
Bonds issued by multilateral development banks	AAA	In-house and Fund Manager	20% in-house 40% Investec	In-house see note 1, Investec see note 2
Sovereign bond issues (other than the UK govt)	AAA	In-house and Fund Manager	20% in-house 40% Investec	In-house see note 1, Investec see note 2

Note 1. Award of “Creditworthiness” Colour by Sector Treasury services as detailed in paragraph 11.2

** If forward deposits are to be made, the forward period plus the deal period should not exceed one year in aggregate.

N.B. buy and hold may also include sale at a financial year end and repurchase the following day in order to accommodate the requirements of SORP.

Note 2, Inclusion within the Investec approved Counterparty list as detailed in Section 11.2.

Note 3, Investec limits – Portfolio average to be up to 3 years, individual investments to a maximum of 10 years.

APPENDIX 6

Approved countries for investments – based on lowest available rating

AAA

- Australia
- Canada
- Denmark
- Finland
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland
- U.K.

AA+

- France
- Hong Kong
- U.S.A

AA

- Abu Dhabi
- Qatar
- UAE

AA-

- Belgium
- Japan
- Saudi Arabia

APPENDIX 7

Amendments to the Treasury Management Practices

1. Amendment to sub-section 8 of section 1.1.1 Policy on the use of credit risk analysis techniques – Amendments are highlighted with shading.

8. Diversification: this organisation will avoid concentrations of lending and borrowing by adopting a policy of diversification. It will therefore use the following: -
 - Maximum amount to be placed with any one institution - £25 million and for those with a sector duration of less than 12 months £20 million.
 - Group limits where a number of institutions are under one ownership – maximum of £25 million and for those with a sector duration of less than 12 months £20 million.
 - Country limits – a minimum sovereign rating of AA- from Fitch Ratings (or equivalent) is required for an institution to be placed on our approved lending list, with the exception of United Kingdom, where there is no restriction on the sovereign credit rating. The maximum investment in any one country is £40 million with the exception of UK which is unlimited. The list of countries which currently meet this criteria is: -

AAA	AA+	AA	AA-
Australia	France	Abu Dhabi	Belgium
Canada	Hong Kong	Qatar	Japan
Denmark	U.S.A.	UAE	Saudi Arabia
Finland			
Germany			
Luxembourg			
Netherlands			
Norway			
Singapore			
Sweden			
Switzerland			
U.K.			

2 Amendment to paragraph 14 from Funds invested with Fund Managers within section 1.1.1- Amendments have been highlighted with shading

- Country limits – a minimum sovereign rating of AA- from Fitch Ratings (or equivalent) is required for an institution to be placed on our approved lending list, with the exception of United Kingdom, where there is no restriction on the sovereign credit rating. The maximum investment in any one country is £40 million with the exception of UK which is unlimited. The list of countries which currently meet this criteria is: -

AAA	AA+	AA	AA-
Australia	France	Abu Dhabi	Belgium
Canada	Hong Kong	Qatar	Japan
Denmark	U.S.A.	UAE	Saudi Arabia
Finland			
Germany			
Luxembourg			
Netherlands			
Norway			
Singapore			
Sweden			
Switzerland			
U.K.			

4. Amendment to Extract from - 1.3.1 Details of approved interest rate exposure limits the overall borrowing limit 2012-13 £435,915,000