Report for Resolution

Report to	Council 22 March 2011	10
Report of	Head of Finance	
Subject	Treasury Management Strategy 2011/12	

Purpose

This report outlines the Council's prudential indicators for 2011/12 through to 2013/14 and sets out the expected treasury operations for this period. It fulfils three key reports required by the Local Government Act 2003:

- *The reporting of the prudential indicators as required by the CIPFA Prudential Code for Capital Finance in Local Authorities (Appendix A);*
- *The Minimum Revenue Provision (MRP) Policy, as required by Regulation under the Local Government and Public Involvement in Health Act 2007 (Appendix A);*
- *The treasury strategy in accordance with the CIPFA Code of Practice on Treasury Management (Appendix B);*

The investment strategy is in accordance with the Department of Communities and Local Government investment guidance (Appendix B).

A summary report outlines the key requirements from these reports.

Recommendations

This report outlines the Council's prudential indicators for 2011/12 – 2013/14 and sets out the expected treasury operations for this period. It fulfils four key legislative requirements:

- The reporting of the **prudential indicators,** setting out the expected capital activities (as required by the CIPFA Prudential Code for Capital Finance in Local Authorities - Appendix A). The treasury management prudential indicators are now included as treasury indicators in the CIPFA Treasury Management Code of Practice;
- The Council's **Minimum Revenue Provision (MRP) Policy**, which sets out how the Council will pay for capital assets through revenue each year (as required by Regulation under the Local Government and Public Involvement in Health Act 2007 – Also Appendix A);
- The **treasury management strategy statement** which sets out how the Council's treasury service will support the capital decisions taken above, the day to day treasury management and the limitations on activity through treasury prudential indicators. The key indicator is the **Authorised Limit**, the maximum amount of debt the Council could afford in the short term, but which would not be sustainable in the longer term. This is the Affordable Borrowing Limit required by s3 of the Local Government Act 2003. This is in accordance with the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code and shown at Appendix B;
- The **investment strategy** which sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss. This

strategy is in accordance with the CLG Investment Guidance. And also shown in Appendix B.

The above policies and parameters provide an approved framework within which the officers undertake the day to day capital and treasury activities.

The Council is recommended to approve each of the key elements of these reports, and recommend these to Council:

1. **The Prudential Indicators and Limits for 2011/12 to 2013/14 contained within Appendix A of the report, including the Authorised Limit Prudential Indicator.**
2. **The Minimum Revenue Provision (MRP) Statement contained within Appendix A which sets out the Council's policy on MRP.**
3. **The Treasury Management Strategy 2011/12 to 2013/14, and the treasury Prudential Indicators contained within Appendix B.**
4. **The Investment Strategy 2011/12 contained in the treasury management strategy (Appendix B), and the detailed criteria included in Annex B1.**

Financial Consequences

The report has no direct financial consequences however it does set the guidelines for how the Council manages its borrowing and investment resources

Contact Officers

Barry Marshall 01603 212556

The Capital Prudential Indicators 2011/12-2013/14

Introduction

1. The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected capital activity or introduces limits upon that activity, reflecting the outcome of the Council's underlying capital appraisal systems. This report updates currently approved indicators and introduces new indicators for 2013/14.
2. Within this overall prudential framework there is an impact on the Council's treasury management activity – as it will directly impact on borrowing or investment activity. As a consequence the treasury management strategy for 20011/12 to 2013/14 is included as Appendix B to complement these indicators. Some of the prudential indicators are shown in the treasury management strategy to aid understanding.

The Capital Expenditure Plans

3. The Council's capital expenditure plans are summarised below and this forms the first of the prudential indicators. A certain level of capital expenditure is grant supported by the Government; any decisions by the Council to spend above this level will be considered unsupported capital expenditure. This unsupported capital expenditure needs to have regard to:
   - Service objectives (e.g. strategic planning);
   - Stewardship of assets (e.g. asset management planning);
   - Value for money (e.g. option appraisal);
   - Prudence and sustainability (e.g. implications for external borrowing and whole life costing);
   - Affordability (e.g. implications for the council tax and rents);
   - Practicality (e.g. the achievability of the forward plan).
4. The revenue consequences of capital expenditure, particularly the unsupported capital expenditure, will need to be paid for from the Council's own resources.
5. This capital expenditure can be paid for immediately (by applying capital resources such as capital receipts, capital grants etc., or revenue resources), but if these resources are insufficient any residual capital expenditure will add to the Council's borrowing need.
6. The key risks to the plans are that the level of Government support has been estimated and is therefore maybe subject to change. Similarly some estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale. For instance anticipated asset sales may be postponed due to the poor condition of the property market.

Appendix A

The Capital Prudential Indicators 2011/12-2013/14

7. The Council is asked to approve the summary capital expenditure projections below. This forms the first prudential indicator:

Capital Expenditure £m	2010/11 Original	2010/11 Revised	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate
Non-HRA	9,704	9,704	5,860	3,365	1,850
HRA	22,529	5,759	20,148	15,748	15,821
Total Expenditure	**32,233**	**15,463**	**26,044**	**19,113**	**15,821**
Financed by:					
Capital receipts	12,095	3,117	5,557	4,637	4,543
Capital grants	17,415	12,346	15,321	11,219	11,478
Capital reserves	-	-	-	-	-
Revenue	2,723	-	5,166	3,257	2,192
Total Resources	**32,233**	**15,463**	**26,044**	**19,113**	**18,213**
Net financing need for the year	**-**	**-**	**-**	**-**	**(542)**

8. Other long term liabilities – The above financing need excludes other long term liabilities, such as PFI and leasing arrangements which already include borrowing instruments.

The Council's Borrowing Need (the Capital Financing Requirement)

9. The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. The capital expenditure above which has not immediately been paid for will increase the CFR.

10. Following accounting changes the CFR includes any other long term liabilities (e.g. PFI schemes) brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for this scheme. The Council currently has £7.8m of such schemes within the CFR.

11. The Council is asked to approve the CFR projections below:

£m	2010/11 Original	2010/11 Revised	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate
Capital Financing Requirement					
CFR – Non Housing	31,239	44,587	37,882	37,877	37,330
CFR - Housing	54,857	46,480	53,180	53,180	53,180
Total CFR	**86,096**	**91,067**	**91,062**	**91,057**	**90,510**
Movement in CFR	**(1,047)**	**(5)**	**(5)**	**(5)**	**(453)**

Movement in CFR represented by					
Net financing need for the year (above)	-	-	-	-	(542)
Less MRP/VRP and other financing movements	(1,047)	(5)	(5)	(5)	89
Movement in CFR	**(1,047)**	**(5)**	**(5)**	**(5)**	**(453)**

12. The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake

additional voluntary payments if required (Voluntary Revenue Provision - VRP). No revenue charge is required for the HRA.

13. CLG Regulations have been issued which require full Council to approve **an MRP Statement** in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement .

14. For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the MRP policy will be:

- **Based on CFR** – MRP will be based on the CFR;

This option provide for an approximate 4% reduction in the borrowing need (CFR) each year.

15. From 1 April 2008 for all unsupported borrowing (including PFI and Finance Leases) the MRP policy will be

- **Asset Life Method** – MRP will be based on the estimated life of the assets, in accordance with the proposed regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction)

This option provide for a reduction in the borrowing need over approximately the asset's life.

The Use of the Council's Resources and the Investment Position

16. The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year end balances for each resource and anticipated day to day cash flow balances.

Year End Resources £m	2010/11 Original	2010/11 Revised	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate
Fund balances	9,735	14,190	14,281	15,272	17,367
Capital receipts	5,134	10,529	5,413	2,500	2,500
Earmarked reserves	832	737	737	737	737
S106	3,282	4,874	776	-	-
Total Core Funds	**18,983**	**30,330**	**21,207**	**18,509**	**20,604**
Working Capital*	14,194	308,984	306,984	304,984	304,984
Expected Investments	**28,300**	**45,000**	**42,000**	**40,000**	**40,000**

*Working capital balances shown are estimated year end; these may be higher mid year

Affordability Prudential Indicators

17. 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 Council's overall finances. The Council is asked to approve the following indicators:

18. **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 net of investment income) against the net revenue stream.

The Capital Prudential Indicators 2011/12-2013/14

%	2010/11 Original	2010/11 Revised	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate
Non-HRA	6.40	6.40	6.63	6.50	6.40
HRA	13.23	13.23	13.71	13.44	13.23

19. The estimates of financing costs include current commitments and the proposals in this budget report.

20. **Estimates of the incremental impact of capital investment decisions on the Council Tax** – This indicator identifies the revenue costs associated with ***proposed changes*** (note this is an amendment to previous Prudential Code) to the three year capital programme recommended in this budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

21. **Incremental impact of capital investment decisions on the Band D Council Tax**

£	Original 2010/11	Proposed Budget 2010/11	Forward Projection 2011/12	Forward Projection 2012/13	Forward Projection 2013/14
Council Tax - Band D	-	-	-	-	-

22. **Estimates of the incremental impact of capital investment decisions on Housing Rent levels** – Similar to the Council tax calculation this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in this budget report compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

23. **Incremental impact of capital investment decisions Housing Rent levels**

£	Original 2009/10	Proposed Budget 2009/10	Forward Projection 2010/11	Forward Projection 2011/12	Forward Projection 2012/13
Weekly Housing Rent levels	-	-	-	-	-

This indicator shows the revenue impact on any newly proposed changes, although any discrete impact will be constrained by rent controls.

Treasury Management Strategy 2011/12-2013/14

1. The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators in Appendix A consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures the Council meets its balanced budget requirement under the Local Government Finance Act 1992. .
2. The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). This Council adopted the Code of Practice on Treasury Management on 2 April 2002.
3. As a result of adopting the Code the Council also adopted a Treasury Management Policy Statement. This adoption is the requirements of one of the prudential indicators.
4. The Constitution, Policy and the Council's Financial Regulations require an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming 3 years. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced after the year-end to report on actual activity for the year, and a new requirement of the revision of the Code of Practice is that there is a mid-year monitoring report.
5. This strategy covers:
   - The Council's debt and investment projections;
   - The Council's estimates and limits on future debt levels;
   - The expected movement in interest rates;
   - The Council's borrowing and investment strategies;
   - Treasury performance indicators;
   - Specific limits on treasury activities;

Debt and Investment Projections 2011/12 – 2013/14

6. 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. The expected maximum debt position during each year represents the Operational Boundary prudential indicator, and so may be different from the year end position. The table also highlights the expected change in investment balances.

£m	2010/11 Revised	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate
External Debt				
Debt at 1 April	83,529	83,529	83,529	96.930
Expected change in debt	-	-	13,400	-
Debt at 31 March	83,539	83,529	96,930	96,930
Operational Boundary	**85,683**	**85,469**	**98,707**	**98,565**
Investments				
Total Investments at 31 March	45,000	42,000	40,000	40,000
Investment change	21,985	(3,000)	(2,000)	-

Treasury Management Strategy 2011/12-2013/14

7. The related impact of the above movements on the revenue budget are:

£m	2010/11 Revised	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate
Revenue Budgets				
Interest on Borrowing	6,663	6,721	6,754	6,641
Related HRA Charge	3,347	3,376	3,393	3,336
Net General Fund Borrowing Cost	3,316	3,345	3,361	3,305
Investment income	1,662	727	950	975

Limits to Borrowing Activity

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

9. For the first of these the Council needs to ensure that its total borrowing net of any investments, 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 2010/11 and the following two financial years (the relevant comparative figures are highlighted). This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

£m	2010/11 Revised	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate
External Loans	91,402	100,235	101,926	100,604
Plus Other long term liabilities	435	425	415	405
Gross Borrowing	91,837	100,660	102,341	101,009
Less Investments	45,000	42,000	40,000	40,000
Net Borrowing	46,837	55,660	62,341	61,009
CFR*	91,067	91,062	91,057	90,510

* - Under the Prudential Code revision any falls in the CFR are ignored.

10. The Director of Finance 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.

11. The Authorised Limit for External Debt – A further key prudential indicator represents a control on the overall level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by full Council. 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.

12. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although no control has yet been exercised.

13. The Council is asked to approve the following Authorised Limit:

Authorised limit £m	2010/11 Revised	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate
Borrowing	103,529	103,529	116,930	116,930
PFI	6,478	5,135	3,792	2,449
Transferred Debt	1,719	1,510	1,352	1,215
Other long term liabilities	435	430	425	420
Total	105,683	105,469	118,707	118,565

14. Borrowing in advance of need – The Council has some flexibility to borrow funds this year for use in future years. The Director of Finance may do this under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. Whilst the Director of Finance will adopt a cautious approach to any such borrowing, where there is a clear business case for doing so borrowing may be undertaken to fund the approved capital programme or to fund future debt maturities. Borrowing in advance will be made within the constraints that:

- It will be limited to no more than 20% of the expected increase in borrowing need (CFR) over the three year planning period; and
- Would not look to borrow more than 6 months in advance of need.

15. Risks associated with any advance borrowing activity will be subject to appraisal in advance and subsequent reporting through the mid-year or annual reporting mechanism.

Expected Movement in Interest Rates[1]

Medium-Term Rate Estimates (averages)

Annual Average %	Bank Rate	Money Rates		PWLB Rates*		
		3 month	1 year	5 year	25 year	50 year
2010/11	0.5	0.7	1.5	2.9	4.7	4.7
2011/12	0.8	1.1	2.0	3.8	5.4	5.3
2012/13	1.8	2.1	3.3	4.2	5.5	5.5
2013/14	3.0	3.3	3.8	4.7	5.7	5.7
2014/15	3.8	4.2	4.5	5.0	5.7	5.7
2015/16	4.3	4.5	4.7	5.3	5.7	5.7

16. There is significant uncertainty with economic forecasts. Whilst short-term rates are expected to remain on hold through most of 2011, inflationary concerns are increasing. Inflation has been above the 2% target for so long the credibility of the MPC may become a greater focus. This will make the MPC's decisions during 2011 a difficult judgment; control inflation or continue to aid the recovery? The MPC will be particularly concerned that the public's inflation expectations could become unhinged. There is a risk that the MPC may feel they will need to take action earlier than Q4, i.e. Q3, in order to reinforce its credibility.

17. The recovery in the economy is well underway; however, the strong rates of growth we have seen are unlikely to be sustained. The Government's

[1] Borrowing rates as complied at 28 February 2011 by Sector Treasury Services Limited

determination to cut the size of the public sector deficit will be a drag upon activity in the medium term. The void left by significant cuts in public spending will need to be filled by a number of alternatives – corporate investment, rising exports (assisted by the fall in the value of sterling) and consumers' expenditure. In terms of sheer magnitude, the latter is the most important and strong growth in this area is by no means certain. The combination of the desire to reduce the level of personal debt, lack of access to credit and continued job uncertainty is likely to weigh heavily upon spending. This will be amplified by fiscal policy tightening, in the Comprehensive Spending Review. Without growth in personal spending remaining robust, any recovery in the economy is set to be weak and protracted.

18. Fiscal support in the US through the extension of tax cuts and monetary support through the extension of quantitive easing (QEII, with the potential for further easing), has had an adverse effect on world bond markets. Following the recent sell off the outlook for long-term interest rates is favourable in the near term, but is set to deteriorate again in the latter part of 2011. The increase in yields will be suppressed by continued investor demand for safe haven instruments following the uncertainties and unfolding tensions within the entire Eurozone. In addition to this, the market has been underpinned by evidence of moderating activity in major economies and the coalition government's determination to deal with the parlous state of public sector finances. These two factors will restrict any deterioration in longer term fixed interest rates in the near term.

19. However, while the UK's fiscal burden will almost certainly ease, it will be a lengthy process and deficits over the next two to three financial years will still require a very heavy programme of gilt issuance. The latest Bank Inflation Report suggests the market will not be able to rely upon Quantitative Easing indefinitely to alleviate this enormous burden.

20. Eventually, the absence of the Bank of England as a continued buyer of gilts will shift the balance between supply and demand in the gilt-edged market. Other investors will almost certainly require some incentive to continue buying government paper.

21. This incentive will take the form of higher yields. The longer end of the curve will suffer from the lack of support from the major savings institutions – pension funds and insurance companies - who will continue to favour other investment instruments as a source of value and performance.

22. Although the FSA has recently delayed implementation of their liquidity requirements, the regulator will still look to ensure banks have necessary short term liquidity. The front end of the curve will benefit from this and will ensure the steeply-positive incline of the yield curve remains intact.

Borrowing Strategy 2011/12 – 2013/14

23. The uncertainty over future interest rates increases the risks associated with treasury activity. As a result the Council will take a cautious approach to its treasury strategy.

24. Long-term fixed interest rates are at risk of being higher over the medium term, and short term rates are expected to rise, although more modestly. The Director of Finance, 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.

25. With the likelihood of long term rates increasing, debt restructuring is likely to focus on switching from longer term fixed rates to cheaper shorter term debt, although the Director of Finance and treasury consultants will monitor prevailing rates for any opportunities during the year.

26. Following the Comprehensive Spending Review the PWLB increased borrowing interest rates by approximately 1%, without changing debt redemption interest rates. This will make PWLB debt rescheduling more problematic in the future.

27. 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.

Investment Strategy 2011/12 – 2013/14

28. **Key Objectives -** The Council's investment strategy primary objectives are safeguarding the re-payment of the principal and interest of its investments on time, then ensuring adequate liquidity, with the investment return being the final objective. Following the economic background above, the current investment climate has one over-riding risk, counterparty security risk. As a result of these underlying concerns officers are implementing an operational investment strategy which tightens the controls already in place in the approved investment strategy.

29. **Risk Benchmarking** – A development in the revised Codes and the CLG Investment Guidance is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are new requirements to the Member reporting, although the application of these is more subjective in nature. Additional background in the approach taken is attached at Annex B2.

30. These benchmarks are simple guides to maximum risk and so may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.

31. Security - The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:
    - 0.05% historic risk of default when compared to the whole portfolio.

32. Liquidity – In respect of this area the Council seeks to maintain:
    - Bank overdraft - £1.3m
    - Liquid short term deposits of at least £1m available with a week's notice.
    - Weighted Average Life benchmark is expected to be 0.45 years, with a maximum of 2.77 years.

33. Yield - Local measures of yield benchmarks are:
    - Investments – Internal returns above the 7 day LIBID rate

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34. And in addition that the security benchmark for each individual year is:

	1 year	2 years	3 years	4 years	5 years
Maximum	0.05%	0.04%	0.03%	0.02%	0.01%

Note: This benchmark is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

35. **Investment Counterparty Selection Criteria -** The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.
- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

36. The Director of Finance will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. This criteria is separate to that which chooses Specified and Non-Specified investments as it provides an overall pool of counterparties considered high quality the Council may use rather than defining what its investments are.

37. The rating criteria use the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with a CIPFA Treasury Management Panel recommendation in March 2009 and the CIPFA Treasury Management Code of Practice.

38. Credit rating information is supplied by our treasury consultants on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance a negative rating watch applying to a counterparty at the minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions).

39. The criteria for providing a pool of high quality investment counterparties (both Specified and Non-specified investments) is:

- **Banks 1 - Good Credit Quality** – the Council will only use banks which:
    - i. Are UK banks; and/or
    - ii. Are non-UK and domiciled in a country which has a minimum Sovereign long term rating of AAA

And have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated):

i. **Short Term** – *F1*

ii. **Long Term** – *A+/A*

iii. **Individual / Financial Strength** – *B/C* (Fitch / Moody's only)

iv. **Support** – *3* (Fitch only)

- **Banks 2 – Guaranteed Banks with suitable Sovereign Support** – In addition, the Council will use banks whose ratings fall below the criteria specified above if all of the following conditions are met:
  - (a) wholesale deposits in the bank are covered by a government guarantee;
  - (b) the government providing the guarantee is rated "AAA" by all three major rating agencies (Fitch, Moody's and Standard & Poors); and
  - (c) the Council's investments with the bank are limited to amounts and maturities within the terms of the stipulated guarantee.
- **Banks 3 – Eligible Institutions** - The organisation was considered an Eligible Institution for the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008, with the necessary short and long term ratings required in Banks 1 above. These institutions were subject to suitability checks before inclusion.
- **Banks 4** – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.
- **Bank Subsidiary and Treasury Operations** – the Council will use these where the parent bank has the necessary ratings outlined above.
- **Building Societies** – the Council will *use* all Societies which meet the ratings for banks outlined above and

  i. The investment is subject to 1% of the society's assets; and

  ii. Have assets in excess of *£250m.*
- **Money Market Funds** – where the investees within the fund accord with the rating requirements set out above
- **UK Government** (including gilts and the DMADF)
- **Local Authorities, Parish Councils etc**
- **Supranational institutions**

A limit of 2% will be applied to the use of Non-Specified investments

32. Country and sector considerations - Due care will be taken to consider the country, group and sector exposure of the Council's investments. In part the country selection will be chosen by the credit rating of the Sovereign state in Banks 1 above. In addition:

- no more than £5m will be placed with any non-UK country at any time;
- limits in place above will apply to Group companies;
- Sector limits will be monitored regularly for appropriateness.

40. **Use of additional information other than credit ratings** – Additional requirements under the Code of Practice require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

41. **Time and Monetary Limits applying to Investments** - The time and monetary limits for institutions on the Council's Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):

	Fitch (or equivalent)	**Money Limit**	**Time Limit**
Limit 1 Category	*F1, A*	£5m	4 yrs
Limit 2 Category	Unrated Building Societies	£5m or 1%	4 yrs
Other Institution Limits	-	£5m	364 days
Guaranteed Organisations	-	£5m	3 months

42. The proposed criteria for Specified and Non-Specified investments are shown in Annex B1 for approval.

43. In the normal course of the council's cash flow operations it is expected that both Specified and Non-specified investments will be utilised for the control of liquidity as both categories allow for short term investments.

44. The use of longer term instruments (greater than one year from inception to repayment) will fall in the Non-specified investment category. These instruments will only be used where the Council's liquidity requirements are safeguarded. This will also be limited by the longer term investment limits.

45. **Economic Investment Considerations** - Expectations on shorter-term interest rates, on which investment decisions are based, show likelihood of the current 0.5% Bank Rate remaining flat but with the possibility of a rise in mid/late-2011. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts.

46. **The criteria for choosing counterparties set out above provide a sound approach to investment in "normal" market circumstances. Whilst Members are asked to approve this base criteria above, under the exceptional current market conditions the Director of Finance may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval. These restrictions will remain in place until the banking system returns to "normal" conditions. Similarly the time periods for investments will be restricted.**

47. Examples of these restrictions would be the greater use of the Debt Management Deposit Account Facility (DMADF – a Government body which accepts local authority deposits), Money Market Funds, and strongly rated institutions. The credit criteria have been amended to reflect these facilities.

Sensitivity to Interest Rate Movements

48. Future Council accounts will be required to disclose the impact of risks on the Council's treasury management activity. Whilst most of the risks facing the treasury management service are addressed elsewhere in this report (credit risk, liquidity risk, market risk, maturity profile risk), the impact of interest rate risk is discussed but not quantified. The table below highlights the estimated impact of a 1% increase/decrease in all interest rates to the estimated treasury management costs/income for next year. That element of the debt and investment portfolios which are of a longer term, fixed interest rate nature will not be affected by interest rate changes.

£m	**2011/12 Estimated + 1%**	**2011/12 Estimated - 1%**
Revenue Budgets		
Interest on Borrowing	*	*
Net General Fund Borrowing Cost	*	*
Investment income	502	(499)

***** No impact on borrowing as all borrowing is at a fixed rate of interest

Treasury Management Limits on Activity

49. There are four further treasury activity limits, which were previously prudential indicators. The purpose of these are 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/improve performance. The indicators are:

- Upper limits on variable interest rate exposure – This identifies a maximum limit for variable interest rates based upon the debt position net of investments
- Upper limits on fixed interest rate exposure – Similar to the previous indicator this covers a maximum limit on fixed interest rates.
- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.
- Total principal funds invested for greater than 364 days – These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

50. The Council is asked to approve the limits:

£m	2011/12	2012/13	2013/14
Interest rate Exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	20%	20%	20%
Limits on fixed interest rates:			
• ***Debt only***	100%	100%	100%
• ***Investments only***	100%	100%	100%
Limits on variable interest rates			
• **Debt only**	20%	20%	20%
• **Investments only**	20%	20%	20%
Maturity Structure of fixed interest rate borrowing 2011/12			
		Lower	**Upper**
Under 12 months		0%	10%
12 months to 2 years		0%	10%
2 years to 5 years		0%	30%
5 years to 10 years		0%	50%
10 years and above		0%	95%
		Lower	**Upper**
Under 12 months		0%	10%
12 months to 2 years		0%	10%
2 years to 5 years		0%	30%
5 years to 10 years		0%	50%
10 years and above		0%	95%
Maximum principal sums invested > 364 days			
Principal sums invested > 364 days	£8m	£8m	£8m

Indicators for debt only and investments only as well as fixed and variable debt maturity profile have been included as local indicators.

Performance Indicators

51. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. Examples of performance indicators often used for the treasury function are:

- Debt – Borrowing - Average rate of borrowing for the year compared to average available
- Debt – Average rate movement year on year
- Investments – Internal returns above the 7 day LIBID rate
- Investments – External fund managers - returns 110% above 7 day compounded LIBID.

The results of these indicators will be reported in the Treasury Annual Report.

Treasury Management Advisers

52. The Council uses Sector as its treasury management consultants. The company provides a range of services which include:
    - Technical support on treasury matters, capital finance issues and the drafting of Member reports;
    - Economic and interest rate analysis;
    - Debt services which includes advice on the timing of borrowing;
    - Debt rescheduling advice surrounding the existing portfolio;
    - Generic investment advice on interest rates, timing and investment instruments;
    - Credit ratings/market information service comprising the three main credit rating agencies;
53. Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remains with the Council. This service is subject to regular review.

Member and Officer Training

54. The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for Members and officers. The council provides training in treasury management matters for officers dealing with treasury management and will, during 2011/12 arrange training in treasury management awareness for members

Other Issues

55. The reform of council housing finance is aimed to be implemented in April 2012. Self financing will put the council in the position where it can support its own housing stock from the income generated by that stock. In order to bring about this change, there will be a readjustment of the council's housing debt, which will give a debt level that the council can support. This will require the council to take on additional borrowing currently estimated at £145m. The council will be working with their treasury management advisors to ensure that the debt taken out is the most cost efficient for the council and that the maturity profile of any new debt is appropriate and takes consideration of that for the existing debt.

    In addition, the council will need to allocate existing borrowing between housing and the general fund as the current statutory method of apportioning debt charges between the general fund and the HRA will cease.

    Once the details of the HRA self financing are finalised, a new treasury management strategy will be submitted to Council.

Treasury Management Practice (TMP) 1 – Credit and Counterparty Risk Management

The CLG issued Investment Guidance in 2010, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds which are under a different regulatory regime.

The key intention of the Guidance is to maintain the current requirement for Councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council 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 1 April 2002 and will apply its principles to all investment activity. In accordance with the Code, the Director of Finance has produced its treasury management practices (TMPs). This part, TMP 1(5), covering investment counterparty policy requires approval each year.

Annual Investment Strategy - 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:

- The strategy guidelines for choosing and placing investments, particularly non-specified investments.
- The principles to be used to determine the maximum periods for which funds can be committed.
- Specified investments the Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
- 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.

The investment policy proposed for the Council is:

Strategy Guidelines – The main strategy guidelines are contained in the body of the treasury strategy statement.

Specified Investments – These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments which would not be defined as capital expenditure with:

1. The UK Government (such as the Debt Management Account deposit facility, UK Treasury Bills or a Gilt with less than one year to maturity).
2. Supranational bonds of less than one year's duration.
3. A local authority, parish council or community council.
4. Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. For category 4 this covers pooled investment vehicles, such as money market funds, rated *as above* by Standard and Poor's, Moody's or Fitch rating agencies.
5. A body that is considered of a high credit quality (such as a bank or building society). For category 5 this covers bodies with a minimum short term rating of

Treasury Management Practice (TMP) 1 – Credit and Counterparty Risk Management

AAA (or the equivalent) as rated by Standard and Poor's, Moody's or Fitch rating agencies.

Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies which will be invested in these bodies. This criteria is contained in the table in section 32 of Appendix B

Non-Specified Investments – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non specified investments would include any sterling investments with:

	Non Specified Investment Category	**Limit (£ or %)**
a.	**Supranational Bonds greater than 1 year to maturity** **(a) Multilateral development bank bonds** - These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Investment Bank etc.). **(b) A financial institution that is guaranteed by the United Kingdom Government** (e.g. The Guaranteed Export Finance Company {GEFCO}) The security of interest and principal on maturity is on a par with the Government and so very secure, and these bonds usually provide returns above equivalent gilt edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£5m
b.	**Gilt edged securities** with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£5m
c.	The Council's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.	£2m
d.	**Building societies not meeting the basic security requirements under the specified investments**. The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings. The Council may use such building societies which were originally considered Eligible Institutions and have a minimum asset size of £*250*m, but will restrict these type of investments to 1% of its assets size	£5m or 1% of total assets
e.	Any **bank or building society** that has a minimum long term credit rating of A+/A, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	Maximum Limit of 100%, so long as no more than 25% of investments have maturities

Treasury Management Practice (TMP) 1 – Credit and Counterparty Risk Management

		of longer the one year at any one time.
f.	Any **non rated subsidiary** of a credit rated institution included in the specified investment category. These institutions will be included as an investment category subject to having a minimum asset size of £250m and a restriction on the investment amount to 1% of its assets size.	£5m for a maximum of 3 months
g.	**Share capital or loan capital*** in a body corporate – The use of these instruments will be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. Revenue resources will not be invested in corporate bodies. There is a higher risk of loss with these types of instruments	£0
h.	**Pooled property or bond funds*** – The use of these instruments will normally be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. Revenue resources will not be invested in corporate bodies. The key exception to this is an investment in the CCLA Local Authorities Property Fund.	£0

In respect of categories g and h, these will only be considered after obtaining external advice and subsequent Member approval.

The Monitoring of Investment Counterparties - The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Sector as and when ratings change, and counterparties are checked promptly On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Director of Finance, and if required new counterparties which meet the criteria will be added to the list.

Security, Liquidity and Yield Benchmarking

Benchmarking and Monitoring Security, Liquidity and Yield in the Investment Service - A proposed development for Member reporting is the consideration and approval of security and liquidity benchmarks.

These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons in the Annual Treasury Report.

Yield – These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are Investments – Internal returns above the 7 day LIBID rate.

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. However they have not previously been separately and explicitly set out for Member consideration. Proposed benchmarks for the cash type investments are below and these will form the basis of future reporting in this area. In the other investment categories appropriate benchmarks will be used where available.

Liquidity – This is defined as “having adequate, though not excessive cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives” (CIPFA Treasury Management Code of Practice). In respect of this area the Council seeks to maintain:

- Bank overdraft - £1.3m
- Liquid short term deposits of at least £1m available with a week’s notice.

The availability of liquidity and the term risk in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – shorter WAL would generally embody less risk. In this respect the proposed benchmark is to be used:

- WAL benchmark is expected to be 0.45 years, with a maximum of 2.77 years**.**

Security of the investments – In context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody’s and Standard and Poors). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council’s investment strategy. The table beneath shows average defaults for differing periods of investment grade products for each Fitch/Moody’s Standard and Poors long term rating category over the period 1990 to 2009.

Years	1	2	3	4	5
AAA	0.00%	0.01%	0.05%	0.10%	0.17%
AA	0.03%	0.06%	0.08%	0.14%	0.20%
A	0.08%	0.22%	0.37%	0.52%	0.70%
BBB	0.24%	0.68%	1.19%	1.79%	2.42%
BB	1.22%	3.24%	5.34%	7.31%	9.14%
B	4.06%	8.82%	12.72%	16.25%	19.16%
CCC	24.03%	31.91%	37.73%	41.54%	45.22%

Security, Liquidity and Yield Benchmarking

The Council's minimum long term rating criteria is currently "A", meaning the average expectation of default for a one year investment in a counterparty with a "A" long term rating would be 0.08% of the total investment (e.g. for a £1m investment the average loss would be £800). This is only an average - any specific counterparty loss is likely to be higher - but these figures do act as a proxy benchmark for risk across the portfolio.

The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables, is:

- 0.05% historic risk of default when compared to the whole portfolio.

And in addition that the security benchmark for each individual year is:

	1 year	2 years	3 years	4 years	5 years
Maximum	0.05%	0.04%	0.03%	0.02%	0.01%

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members in the Investment Annual Report. As this data is collated, trends and analysis will be collected and reported. Where a counterparty is not credit rated a proxy rating will be applied.