BUDGET AND RENT SETTING REPORT AND TREASURY MANAGEMENT STRATEGY REPORT 2011/12-2013/14

To:	**Governance and Audit Committee – 13th January 2011**
Main Portfolio Area:	**Finance and Corporate Services**
By:	**Treasury and Capital Accountant**
Classification:	**Unrestricted**

Summary: **This report is to provide the Governance and Audit Committee with the proposed Treasury Management Strategy Report for 2011-12 for their approval.**

<u>For Decision</u>

1.0 Introduction and Background

1.1 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 – as per section 2.0 of this report). 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 within section 2.0 of this report);
- 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 is shown in section 3.0 of this report;
- 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 is also shown in section 3.0 of this report.

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

2.0 The Capital Prudential Indicators 2011/12 – 2013/14

2.1 Introduction

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.

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 section 3.0 within this report, to complement these indicators. Some of the prudential indicators are shown in the treasury management strategy to aid understanding.

2.2 The Capital Expenditure Plans

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).

The revenue consequences of capital expenditure, particularly the unsupported capital expenditure, will need to be paid for from the Council's own resources.

This capital expenditure can be paid for immediately (by applying capital resources such as capital receipts, capital grants, or revenue resources etc.), but if these resources are insufficient any residual capital expenditure will add to the Council's borrowing need.

The key risks to the plans are that the level of Government support has been estimated and therefore may be 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.

Due to the current financial restrictions the authority is facing, the capital programme has been revised to ensure that the projects of highest corporate priority and that are income generating are completed first. All other projects are to remain on hold but are kept in order of priority so that should the capital receipts exceed expectations, then the first project on that reserve list will be started.

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	12.022	16.755	10.065	3.963	1.523
HRA	4.773	4.968	3.266	2.660	2.660
Total	16.795	21.723	13.331	6.623	4.183
Financed by:					
Capital receipts	1.796	2.636	0.760	0.770	0.500
Capital grants	8.494	13.391	4.452	3.223	1.023
Capital reserves	2.595	3.013	3.116	2.130	2.160
Revenue	0.100	0.980	1.000	0.500	0.500
Net financing need for the year	**3.810**	**1.703**	**4.003**	**0.000**	**0.000**

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

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.

Following accounting changes the CFR includes any other long term liabilities (e.g. finance leases and PFI schemes) that are 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 £3.418m of such schemes within the CFR.

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	17.411	20.196	23.502	22.782	21.813
CFR - Housing	23.966	23.966	23.966	23.966	23.966
Total CFR	**41.377**	**44.162**	**47.468**	**46.748**	**45.779**
Movement in CFR	**1.529**	**1.029**	**3.306**	**(0.720)**	**(0.969)**

Movement in CFR represented by					
Net financing need for the year (above)	2.059	1.703	4.003	0.000	0.000
Less MRP/VRP and other financing movements	(0.530)	(0.674)	(0.697)	(0.720)	(0.969)
Movement in CFR	**1.529**	**1.029**	**3.306**	**(0.720)**	**(0.969)**

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.

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 to replace existing Regulations, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement:

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

- **Existing practice** - MRP will follow the existing practice outlined in former CLG Regulations (Option 1);

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

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) (Option 3);

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

Principal repayments of any loan will impact on the balance sheet by reducing the authority's long term liabilities and also its cash balances. The key issue for the authority is whether it has sufficient cash balances at the time to make the repayment. This will need to be considered before any new borrowing is pursued.

The Minimum Revenue Provision (MRP) charge to the General Fund is the amount shown in the accounts for the principal debt repayment, that hits the bottom line, and so is part of the Council Tax calculations. By using the asset life method, the MRP spreads the cost over more financial years so that the impact on the General Fund is reduced.

However, the interest that must be paid on borrowing is a true cost to the general fund. This must be budgeted for and where borrowing is required for capital projects, an income stream will need to be identified to pay for this.

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

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	1.883	1.883	1.883	1.883	1.883
Capital receipts	1.826	2.636	0.760	0.770	0.500
Earmarked reserves	3.095	3.095	1.718	1.464	1.464
Total Core Funds	**6.804**	**7.614**	**4.361**	**4.117**	**3.847**
Working Capital*	**20.377**	**21.099**	**19.405**	**19.688**	**19.720**

Under/over borrowing	13.377	14.099	13.405	12.688	11.720
Expected Investments	**7.000**	**7.000**	**6.000**	**7.000**	**8.000**

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

2.5 **Affordability Prudential Indicators**

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:

2.6 **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 amount to be met from local taxpayers and central government grant, and rent income for the HRA).

%	2010/11 Original	2010/11 Revised	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate
Non-HRA	4%	4%	3%	2%	2%
HRA	10%	10%	9%	9%	8%

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

2.7 **Estimates of the incremental impact of capital investment decisions on the Council Tax**

This indicator identifies the revenue costs associated with proposed changes 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.

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

£m	Original 2010/11	Proposed Budget 2010/11	Forward Projection 2011/12	Forward Projection 2012/13	Forward Projection 2013/14
Council Tax - Band D	0	0	0	0	0.65

2.8 **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.

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	0	0	0	0	0

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

3.0 Treasury Management Strategy 2011/12-2013/14

3.1 The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators in section 2.0 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.

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 revised Code of Practice on Treasury Management on the 25/02/2010.

As a result of adopting the Code, the Council also adopted a Treasury Management Policy Statement (21/08/2003). This adoption is the requirements of one of the prudential indicators.

The Constitution requires 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.

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;

3.2 Debt and Investment Projections 2011/12 – 2013/14

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	26.646	26.646	30.646	30.646
Expected change in debt	0.000	4.000	0.000	0.000
Debt at 31 March	**26.646**	**30.646**	**30.646**	**30.646**
Operational Boundary	**37.000**	**43.000**	**41.000**	**42.500**
Investments				
Total Investments as at 31 March	7.000	6.000	7.000	8.000
Investment change	**0.000**	**(1.000)**	**1.000**	**1.000**

The related impact of the above movements on the revenue budget is:

£m	2010/11 Revised	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate
Revenue Budgets				
Interest on Borrowing	1.503	1.602	1.512	1.470
Related HRA Charge	0.563	0.966	0.870	0.839
Net General Fund Borrowing Cost	0.940	0.636	0.642	0.631
Investment income	0.128	0.126	0.175	0.280

3.3 **Limits to Borrowing Activity**

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

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	26.646	30.646	30.646	30.646
Plus Other long term liabilities	3.418	3.418	3.418	3.418
Gross Borrowing	30.064	34.064	34.064	34.064
Less Investments	7.000	6.000	7.000	8.000
Net Borrowing	**23.064**	28.064	27.064	26.064
CFR*	44.162	47.468	47.468	**46.748**

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

The Section 151 Officer reports that the Council has complied with this prudential indicator in the current financial year and does not envisage difficulties in the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

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.

The Authorised Limit 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.

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	27.000	36.000	36.000	36.000
Other long term liabilities	20.418	15.000	14.000	14.000
Total	47.418	51.000	50.000	50.000

Borrowing in advance of need – The Council has some flexibility to borrow funds this year for use in future years. The Section 151 Officer 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 Section 151 Officer 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:

- The authority would not look to borrow more than 18 months in advance of need.

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.

3.4 Expected Movement in Interest

Medium-Term Rate Estimates (averages)

Annual Average %	Bank Rate	Money Rates		PWLB Borrowing Rates		
		3 month	1 year	5 year	25 year	50 year
2010/11	0.5	0.7	1.5	2.6	4.6	4.7
2011/12	0.7	1.0	1.8	3.3	5.3	5.4
2012/13	1.7	2.0	2.8	4.2	5.5	5.6
2013/14	3.1	3.2	3.7	4.8	5.6	5.7
2014/15	4.0	4.2	4.5	5.6	5.6	5.8
2015/16	4.0	4.2	4.2	5.3	5.5	5.5

Short-term rates are expected to remain on hold for a considerable time. The recovery in the economy has commenced and recent growth data has come in at the high side of expectations. Nevertheless, this higher rate is unlikely to be sustained, with growth expected to revert back to more insipid levels. The danger of a double-dip recession is fading but the crisis in the euro-zone, the prospects of tight economic policies at home and tenuous consumer confidence means the threat has still not evaporated completely.

The Office for Budget Responsibility has presented a realistically downbeat view of the economy's recovery prospects over the short and medium term, projecting that growth will struggle to exceed its trend rate in the current Parliament. The Government's determination to cut the size of the public sector deficit considerably quicker than its predecessor will be a drag upon activity in the medium term.

The void left by significant cuts in public spending will have to be filled by a number of alternatives – corporate investment, rising exports and consumers' expenditure. In terms of sheer magnitude, the latter is the most important and a strong recovery in this area is by no means certain. The combination of the desire to reduce the level of personal debt and continued job uncertainty is likely to weigh heavily upon spending. This will be amplified by fiscal policy tightening, outlined in the Budget and expanded upon in the 20 October 2010 Comprehensive Spending Review. Without a rebound in personal spending, any recovery in the economy is set to be weak and protracted.

The Bank of England admits that inflation will remain above target until 2012. Inflation performance remains a key risk to the future course of interest rates. Nevertheless, the perceived need to counter the fiscal squeeze via accommodative monetary policy suggests that barring deterioration from the current situation, the MPC will be prepared to hold rates at very low levels until the latter stages of 2011.

The outlook for long-term interest rates is favourable in the near term but is set to deteriorate in the latter part of 2011. 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 decelerating activity in major economies and the coalition government's apparent determination to deal with the parlous state of public sector finances. These two factors will restrict any deterioration in gilt market performance in the near term.

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.

Eventually, the absence of the Bank of England as the largest 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.

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.

The front end of the curve will benefit from heavy purchases by banks as they seek to meet the FSA's proposed liquidity requirements. This will be a major benefit to the Government's gilt funding operations in the near term and will ensure the steeply-positive incline of the yield curve remains intact.

3.5 **Borrowing Strategy 2011/12 – 2013/14**

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.

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 Section 151 Officer, 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.

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 Section 151 Officer and treasury consultants will monitor prevailing rates for any opportunities during the year.

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.

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.

4.0 Investment Strategy 2011/12 – 2013/14

4.1 Key Objectives

The Council's investment strategy primary objectives are safeguarding the re-payment of the principal and interest of its investments on time, and 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.

4.2 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 in section 6.0 of this report.

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.

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.**

Liquidity – In respect of this area the Council seeks to maintain:

- Bank overdraft - £0.5m
- Liquid short term deposits of at least £5m available with a week's notice.
- Weighted Average Life benchmark is expected to be 0.5 years, with a maximum of 1.0 years.

Yield - Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID rate

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%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**

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

4.3 **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.**

The Section 151 Officer 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.

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.

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 removed from the list, with all others being reviewed in the light of market conditions.

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

- 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
    - iii. Individual/Financial Strength – 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:
  i. meet the ratings for banks outlined above
- Money Market Funds – *AAA*
- UK Government (including gilts and the DMADF)
- Local Authorities, Parish Councils etc
- Supranational institutions

A limit of 0% will be applied to the use of Non-Specified investments as it is the Council's policy not to invest for longer than a one year period at this time.

4.4 **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 10% 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.

4.4 **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.

4.5 **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, Moody's, Standard & Poor's respectively	Money Limit	Time Limit
Upper limit Category	F1+, P1, A1+	**£6m**	**1 yr**
Middle Limit Category	F1, P1, A1	**£5m**	**1 yr**
Debt Management Account Deposit Facility	-	**No Limit**	**6 months**
Money Market Funds	AAA	**£5m**	**1 yr**
Guaranteed Organisations (Eligible Institutions)	-	**£4m**	**1 yr**

The proposed criteria for Specified and Non-Specified investments are shown in section 5.0 for approval.

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.

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 not be used by the Council.

4.6 **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.

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 Section 151 Officer 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.

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.

4.7 **Sensitivity to Interest Rate Movements**

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	0.045	(0.045)
Net General Fund Borrowing Cost	0.045	(0.045)
Investment income	0.140	(0.126)

4.8 **Treasury Management Limits on Activity**

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.

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: • Debt only • Investments only	 51.000 35.000	 50.000 35.000	 50.000 35.000
Limits on variable interest rates • Debt only • Investments only	 51.000 35.000	 50.000 35.000	 50.000 35.000
Maturity Structure of fixed interest rate borrowing 2011/12			
	Lower	**Upper**	

Under 12 months		0%	25%
12 months to 2 years		0%	30%
2 years to 5 years		0%	40%
5 years to 10 years		0%	50%
10 years to 20 years		0%	45%
20 years to 30 years		0%	45%
30 years to 40 years		0%	50%
40 years to 50 years		0%	50%
50 years and above		0%	50%
Maximum principal sums invested > 364 days for 2011-12, 2012-13, 2013-14			
Principal sums invested > 364 days	£0	£0	£0

4.9 **Performance Indicators**

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

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

4.10 **Treasury Management Advisers**

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;

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.

4.11 **Member and Officer Training**

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. This Council has addressed this important issue by:

a. Using our treasury management consultants to provide training for our Members as appropriate. The last training course was held on the 25th January 2010. Members may also attend the basic treasury management training course held by Sector in London.

b. The officer responsible for the daily treasury management function has completed the Association of Corporate Treasurers qualification: International Treasury Management for Public Finance certificate.

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

5.1 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 and will apply its principles to all investment activity. In accordance with the Code, the Section 151 Officer has produced its treasury management practices (TMPs). This part, TMP 1(5), covering investment counterparty policy requires approval each year.

5.2 **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.

5.3 **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 *AAA* 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 F1 (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:

	Fitch, Moody's, Standard & Poor's respectively	Money Limit	Time Limit
Upper limit Category	F1+, P1, A1+	**£6m**	**1 yr**
Middle Limit Category	F1, P1, A1	**£5m**	**1 yr**
Debt Management Account Deposit Facility	-	**No Limit**	**6 months**
Money Market Funds	AAA	**£5m**	**1 yr**
Guaranteed Organisations (Eligible Institutions)	-	**£4m**	**1 yr**

5.4 **Non-Specified Investments**

Non-specified investments are any other type of investment (i.e. not defined as Specified above). The Council do not use non-specified investments.

5.5 **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 Section 151 Officer, and if required new counterparties which meet the criteria will be added to the list.

5.6 **Use of External Fund Managers**

It is the Council's policy not to use external fund managers for any part of its investment portfolio.

6.0 Security, Liquidity and Yield Benchmarking

6.1 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 - £0.5m
- Liquid short term deposits of at least £5m 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 0.5 years, with a maximum of 1.0 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%

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 £300). 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%	0%	0%	0%

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.

7.0 Options

7.1 Set out the various possible options (if any) [Note: on reports to Cabinet and individual Cabinet Members also give reasons why the option(s) not recommended should be rejected.]

8.0 Corporate Implications

8.1 **Financial**

8.1.1 There are no financial implications arising directly from this report.

8.2 **Legal**

8.2.1 There are no legal implications arising directly from this report.

8.3 **Corporate**

8.3.1 The Council would like to continue to improve on its score for Use of Resources, and improving its risk management processes will help towards this.

8.3.2 Failure to undertake this process will impact on the Council's compliance with the Treasury Management Code of Practice.

8.4 **Equity and Equalities**

8.4.1 There are no equity or equalities issues arising from this report.

9.0 Recommendation(s)

9.1 The Governance and Audit Committee 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.

The Investment Strategy 2011/12 contained in the treasury management strategy (Appendix B), and the detailed criteria included in Annex B1.

10.0 Decision Making Process

10.1 Under the treasury Management Code of Practice it is required that the Governance and Audit Committee note this report before it is sent to Council for approval.

10.2 Following the Governance and Audit Committee's approval, this report must go to Cabinet and then Council as part of the Medium Term Financial Strategy.

Future Meeting if applicable: Cabinet	Date: 10/02/2011
And then Council	Date: 24/02/2011

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11.0 Corporate Consultation Undertaken

Finance	Nicola Walker
Legal	Peter Reilly