

Treasury Management Strategy Report 2011/12

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 **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 Communities and Local Government (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 Strategy & Resources Committee is recommended to approve each of the three 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 Treasury Management Strategy 2011/12 to 2013/14, and the treasury Prudential Indicators contained within Appendix B.**
3. **The Investment Strategy 2011/12 contained in the treasury management strategy (Appendix B), and the detailed criteria included in Annexe B1.**

Appendix A

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, and reflects 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 2011/12 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 impact of the recession on the property market.

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

Capital Expenditure	2010/11 Original £'000	2010/11 Revised £'000	2011/12 Estimate £'000	2012/13 Estimate £'000	2013/14 Estimate £'000
Capital Expenditure	2,410	1,712	3,353	735	730
Financed by:					
Capital receipts & reserves	845	1,251	1,145	445	440
Capital grants	350	301	353	290	290
Other contributions	1,215	160	1,855	0	0
Revenue	0	0	0	0	0
Net financing need for the year	0	0	0	0	0

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

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

	2010/11 Original £m	2010/11 Revised £m	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m
Capital Financing Requirement					
CFR	0	0	0	0	0
Total CFR	0	0	0	0	0
Movement in CFR	0	0	0	0	0

Movement in CFR represented by					
Net financing need for the year (above)	0	0	0	0	0
Less MRP/VRP and other financing movements	0	0	0	0	0
Movement in CFR	0	0	0	0	0

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

11. The CFR for the Council over the next three years is zero; this means that the Council does not have a requirement to make MRP to the General Fund.

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

12. 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	2010/11 Original £m	2010/11 Revised £m	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m
Fund balances	2.9	3.0	2.7	2.5	2.3
Capital receipts	4.6	5.1	4.3	4.1	3.9
Earmarked reserves	5.7	5.3	5.0	4.9	4.9
Other accounts	0.7	2.4	0.6	0.6	0.6
Total Core Funds	13.9	15.8	12.6	12.1	11.7
Working Capital*	0.2	0.2	0.2	0.2	0.2
Expected Investments	14.1	16.0	12.8	12.3	11.9

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

Affordability Prudential Indicators

13. 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:

14. **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.

	2010/11 Original %	2010/11 Revised %	2011/12 Estimate %	2012/13 Estimate %	2013/14 Estimate %
Ratio	-3	-2	-2	-2	-2

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

16. **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.

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

	2010/11 Original £	2010/11 Revised £	2011/12 Estimate £	2012/13 Estimate £	2013/14 Estimate £
Total	42,250	62,550	57,250	22,250	22,000
Per Council Tax - Band D Property	1.33	1.97	1.80	0.70	0.69

Appendix B

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 – revised November 2009).
3. As a result of adopting the Code the Council also adopted a Treasury Management Policy Statement in March 2004. This adoption is the requirement of one of the prudential indicators.
4. The policy 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 requirement of the revised 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;
 - Any local treasury issues.

Balanced Budget Requirement

6. It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore, means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from:
 - a. increases in interest charges caused by increased borrowing to finance additional capital expenditure, and
 - b. Any increases in running costs from new capital projects are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

Debt and Investment Projections 2011/12 – 2013/14

7. The borrowing requirement comprises the expected movement in the CFR (Capital Financing Requirement) 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.

	2010/11 Revised £m	2011/12 Estimated £m	2012/13 Estimated £m	2013/14 Estimated £m
External Debt				
Operational Boundary *	0	0	0	0
Investments				
Total Investments at 31 March	16.0	12.8	12.3	11.9
Investment change		-3.2	-0.5	-0.4

- * The operational boundary excludes any reclassification of debt caused through the implementation of IFRS.

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

	2010/11 Revised £'000	2011/12 Estimated £'000	2012/13 Estimated £'000	2013/14 Estimated £'000
Revenue Budgets				
Interest on Borrowing	0	0	0	0
Investment income *	0	160	25	20

- * Investment income is based on a long term average annual rate of return of 5 percent.

Limits to Borrowing Activity

9. Within the prudential indicators there are a number of key indicators to ensure the Council operates its activities within well defined limits
10. 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 2011/12 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.

	2010/11 Revised £m	2011/12 Estimated £m	2012/13 Estimated £m	2013/14 Estimated £m
Gross Borrowing	0	0	0	0
Investments	16.0	12.8	12.3	11.9
Net Borrowing	-16.0	-12.8	-12.3	-11.9
CFR*	0	0	0	0

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

11. 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.

12. 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.

13. 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.

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

Authorised limit	2010/11 Revised £m	2011/12 Estimated £m	2012/13 Estimated £m	2013/14 Estimated £m
Borrowing	5	5	5	5
Other long term liabilities	0	0	0	0
Total	5	5	5	5

15. The Authorised Limit also allows for any potential overdraft position as this will be counted against the overall borrowing and short-term borrowing from the market should a need arise.

Expected Movement in Interest Rates

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	2.6	4.6	4.7
2011/12	0.7	0.9	1.8	3.5	5.3	5.3
2012/13	1.7	1.9	2.8	4.0	5.4	5.4
2013/14	3.1	3.3	3.8	4.8	5.6	5.6
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

* Borrowing Rates

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 Monetary Policy Committee (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 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 quantitative easing (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 Financial Services Agency (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 Council does not envisage any borrowing need during the period of planning shown in this report.

Investment Strategy 2011/12 – 2013/14

24. **Key Objectives** - The Council's investment strategy primary objectives are safeguarding the re-payment of the principal and interest of its investments on time first and ensuring adequate liquidity second – the investment return being a third objective. Following the economic background above, the current investment climate has one over-riding risk consideration: that of 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.
25. **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.
26. 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.
27. Security - The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:
 - 0.02% historic risk of default when compared to the whole portfolio.

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

- Bank overdraft - £200,000
- Liquid short term deposits of at least £1m available with a week's notice.
- Weighted Average Life benchmark is expected to be 0.2 years, with a maximum of 1.0 years.
- A core investment balances of approximately £17 million, although this amount may fluctuate due to cash flow reasons.
- The Council will be able to allocate 100% of its investments to non-specified instruments.
- Yield - Local measures of yield benchmarks for Investments is the rate of returns above the 7 day LIBID rate.

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

	1 year	2 years	3 years	4 years	5 years
Maximum	0.08%	0.22%	0.05%	0.10%	0.17%

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

30. **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.

31. 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 criterion 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.

32. 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.

33. 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.

34. 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-
 - 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 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 have been subject to suitability checks before inclusion, and have access to HM Treasury liquidity if needed.
- **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
 - or are both:
 - ii. Eligible Institutions; and
 - iii. Have assets in excess of £1bn.
- **Money Market Funds – AAA**
- **UK Government** (including gilts and the Debt Management Account Deposit Fund)
- **Local Authorities, Parish Councils etc**
- **Supranational institutions**

There is no restriction on the level of funds that can be invested in Non-Specified investments such as floating rate notes. However, these will only feature within specific funds managed by our external fund manager and are classed as specified investments.

35. All credit ratings will be monitored. The Council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service.
- If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
36. Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on government support for banks and the credit ratings of that government support.
37. **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:
- limits in place above will apply to Group companies;
 - Sector limits will be monitored regularly for appropriateness.
38. **Use of additional information other than credit ratings** – Additional requirements under the Code of Practice now 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.

39. **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)	Moody's	Standard & Poors	Money Limit	Time Limit
Upper Limit Category	F1 / AAA / B / 1	P-1 / Aaa / B	A-1 / AAA	£2.5m	5yrs
Middle Limit Category	F1 / AA- / B / 2	P-1 / Aa3/ B	A-1 / AA-	£2.5m	3yrs
Lower Limit Category	F1 / A- / C / 3	P-1 / A3 / C	A-1 / A	£2.5m	1yrs
Building Society	Meet banks criteria or assets in excess of £1bn and are an 'eligible institution'			£2.5m	9 months
Other Institution Limits -					
DMADF				£2.5m	6 months
Money Market Funds				£2.5m	no limit
Other Local Authorities				£2.5m	1yr
Supranational				£2.5m	5yrs
Gilts				£2.5m	10yrs
Guaranteed Organisations	-			£2.5m	length of guarantee

- The Upper and Middle Limit categories if these are for greater than 1 year will include relatively high rated institutions (at least AA). The Lower Limit Category will normally just be used for unrated subsidiaries and building societies.
 - The Other Institution Limit will be for other local authorities, the DMADF, Money Market Funds and Gilt and Supranational investments. These are all considered high quality names – although not always rated – and therefore will likely have the same limit as the Upper Category. Guaranteed institutions will need to be restricted to the terms of the guarantee.
40. The proposed criteria for Specified and Non-Specified investments are shown in Annexe B1 for approval.
41. 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.
42. 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.

Economic Investment Considerations

43. 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.

44. 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.
45. Examples of these restrictions would be the greater use of the Debt Management Account Deposit 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

46. The Council accounts are 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.

£'000	2011/12 Estimated + 1%	2011/12 Estimated - 1%
Revenue Budgets		
Investment income	+200	-200

Treasury Management Limits on Activity

47. 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.

48. The Committee 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%
Maturity Structure of fixed interest rate borrowing 2010/11			
	Lower	Upper	
Under 12 months	0%	100%	
12 months to 2 years	0%	0%	
2 years to 5 years	0%	0%	
5 years to 10 years	0%	0%	
10 years and above	0%	0%	
Maximum principal sums invested > 364 days			
Principal sums invested > 364 days	50%	50%	50%

Performance Indicators

49. 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:

- Investments – Internal returns above the 7 day LIBID rate

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

Treasury Management Advisers

50. 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;
- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings/market information service comprising the three main credit rating agencies;

51. 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

52. 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 will ensure that appropriate training is available for Members and Officers of the Council.

Annexe B1

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 revised Code at the Strategy & Resources meeting on 30 March 2010 and applies 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 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 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 criterion is:

	Fitch (or equivalent)	Moody's	Standard & Poors	Money Limit	Time Limit
Upper Limit Category	F1 / AAA / B / 1	P-1 / Aaa / B	A-1 / AAA	£2.5m	5yrs
Middle Limit Category	F1 / AA- / B / 2	P-1 / Aa3/ B	A-1 / AA-	£2.5m	3yrs
Lower Limit Category	F1 / A- / C / 3	P-1 / A3 / C	A-1 / A	£2.5m	1yrs
Building Society	Meet banks criteria or assets in excess of £1bn and are an 'eligible institution'			£2.5m	9 months
Other Institution Limits -					
DMADF				£2.5m	6 months
Money Market Funds				£2.5m	no limit
Other Local Authorities				£2.5m	1yr
Supranational				£2.5m	5yrs
Gilts				£2.5m	10yrs
Guaranteed Organisations	-			£2.5m	length of guarantee

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.	<p>Supranational Bonds greater than 1 year to maturity</p> <p>(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.).</p> <p>(b) A financial institution that is guaranteed by the United Kingdom Government (e.g. The Guaranteed Export Finance Company {GEFCO})</p> <p>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.</p>	<p>50% of money invested through external fund manager.</p> <p>Restriction of 5yrs maximum maturity</p>

	Non Specified Investment Category	Limit (£ or %)
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.	50% of money invested through external fund manager. Restriction of 10yrs maximum maturity
c.	<i>The Council's own banker if it fails to meet the basic credit criteria.</i>	In this instance balances will be minimised as far as is possible.
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 are Eligible Institutions and have a minimum asset size of £1bn, but will restrict these types of investments to 9 months.	£2.5m per institution
e.	Any bank or building society that has a minimum long term credit rating of A-, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment). See table above for full limits.	Maximum of 50% on investments over 1yr]
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 the parent bank having the necessary ratings outlined in (e) above and a guarantee from the parent company.	£2.5m per institution
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. The criterion for this type of investment is maximum 10 years to maturity. (There is a higher risk of loss with these types of instruments).	Maximum £2.5m per institution, subject to minimum rating of AA- (long term)

Within categories c and d, and in accordance with the Code, the Council has developed additional criteria to set the overall amount of monies which will be invested in these bodies. This criterion is outlined in the tables above.

In respect of category g, this 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.

Use of External Fund Managers – It is the Council’s policy to use external fund managers for part of its investment portfolio. The fund managers will use both specified and non-specified investment categories, and are contractually committed to keep to the Council’s investment strategy. The terms of the fund managers’ investment policies are in accordance with strategy detailed above and are detailed in the contract with the fund manager. The performance of the manager is reviewed at least quarterly by the Director of Finance and the manager is contractually required to comply with the annual investment strategy.

Annex B2

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 - £200,000
- 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 0.2 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" (amend as necessary), 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	0.08%	0.22%	0.05%	0.10%	0.17%

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.