**Appendix E**

# Treasury Management Strategy Report 2010/11

This report outlines the Council's prudential indicators for 2010/11 – 2012/13 and sets out the expected treasury operations for this period. It fulfils four key legislative requirements as required by the Local Government Act 2003:

- 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. The treasury management prudential indicators are now included as treasury indicators in the CIPFA Treasury Code of Practice (Annex A);
- 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 (Annex A);
- The treasury management strategy statement which sets out how the Council's treasury service will support the capital decisions taken above, the day to day treasury management and the limitations on activity through treasury prudential indicators. The key indicator is the Authorised Limit, the maximum amount of debt the Council could afford in the short term, but which would not be sustainable in the longer term. This is the Affordable Borrowing Limit required by s3 of the Local Government Act 2003. This is in accordance with the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code and shown at Appendix (Annex B);
- The investment strategy which sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss (in accordance with the CLG (Communities for Local Government) investment guidance) (Annex B);

Revised editions of the CIPFA Prudential Code and CIPFA Treasury Management Code of Practice were produced in November 2009. The CLG is currently consulting on changes to the Investment Guidance. The revised guidance arising from these Codes has been incorporated within these reports, with the CLG proposals being incorporated where these do not conflict with current Guidance. If necessary the Investment Strategy contained in Appendix B will be revised if any elements of the final CLG Investment Guidance have not already been covered.

The main changes initiated in the revisions above increase the Members' responsibility in this area. This would require greater Member scrutiny of the treasury policies, increased Member training and awareness and greater frequency of information. The Council has already incorporated these changes within its constitution by delegating responsibility for monitoring and revisions to the Treasury Management Strategy to Governance and Audit Committee. In addition to this the committee has undertaken specific Treasury Management training in September 2009. In addition to this the Council has adopted quarterly reporting on performance in conjunction with an annual report which is presented to the Governance and Audit Committee.

## Appendix E - Annex A

## The Prudential Indicators 2009/10 – 2012/13

### Introduction

1. The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. This report revises the indicators for 2009/10, 2010/11 and 2011/12, and introduces new indicators for 2012/13. Each indicator either summarises the expected activity or introduces limits upon the activity, and reflects the outcome of the Council's underlying capital appraisal systems.
2. Within this overall prudential framework there is a clear impact on the Council's treasury management activity, either through borrowing or investment activity. As a consequence the treasury management strategy for 2010/11 is included as Annex B to complement the indicators, and this report includes the prudential indicators relating to the treasury activity.
3. A number of Prudential Indicators covering treasury management have been moved to the Treasury Management Code of Practice. These Treasury Management indicators are contained within this report.

### The Capital Expenditure Plans

4. 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).
5. The revenue consequences of capital expenditure, particularly the unsupported capital expenditure, will need to be paid for from the Council's own resources.
6. 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.
7. 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 of 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 impact of the recession on the property market.

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

| £m | 2009/10 Revised £ | 2010/11 Estimated £ | 2011/12 Estimated £ | 2012/13 Estimated £ |
|---|---|---|---|---|
| Capital Expenditure | 6.651m | 12.199m | 8.225m | 8.656m |
| Non-HRA | 2.370m | 5.216m | 3.064m | 3.461m |
| HRA | 4.281m | 6.983m | 5.161m | 5.195m |
| Financed by: | | | | |
| Supported Borrowing | 0 | 0.118m | 0 | 0 |
| Capital receipts reserve | 0 | 1.304m | 2.245m | 2.707m |
| Capital grants | 1.008m | 1.400m | 0.254m | 0.254m |
| Capital reserves | 4.237m | 8.377m | 4.161m | 3.695m |
| Revenue | 1.406m | 1.000m | 1.565m | 2.000m |
| Net financing need for the year | 0 | 0 | 0 | 0 |

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

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

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

| £m | 2009/10 Revised | 2010/11 Estimated | 2011/12 Estimated | 2012/13 Estimated |
|---|---|---|---|---|
| Capital Financing Requirement | | | | |
| CFR – Non Housing | 4.883m | 4.806m | 4.614m | 4.429m |
| CFR - Housing | 2.159m | 2.159m | 2.519m | 2.159m |
| Total CFR | 7.042m | 6.965m | 6.773m | 6.588m |
| Movement in CFR | 0.212m | 0.077m | 0.192m | 0.185m |

11. 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). The MRP is the reason for the negative year on year movements in the CFR forecasts shown above.

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

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

- **Existing practice -** MRP will follow the existing practice outline in former CLG Regulations.

14. From 1 April 2008 for all new unsupported borrowing 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 Directive).

**The Use of the Council's resources and the Investment Position**

15. 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 | 2009/10 Revised £ | 2010/11 Estimated £ | 2011/12 Estimated £ | 2012/13 Estimated £ |
|---|---|---|---|---|
| Fund balances | 7.324m | 5.347m | 5.375m | 5.717m |
| Capital receipts | 7.563m | 6.829m | 4.884m | 2.477m |
| HRA reserve | 5.398m | 5.077m | 5.007m | 5.130m |
| Major Repairs Reserve | 6.618m | 3.795m | 3.369m | 3.484m |
| Total Core Funds | **26.903m** | **21.048m** | **18.635m** | **16.808m** |
| Working Capital* | (1.560m) | (1.560m) | (1.560m) | (1.560m) |
| Expected Investments | 25.343m | 19.488m | 17.075m | 15.248m |

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

**Affordability Prudential Indicators**

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

17. **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.

| % | 2009/10 Revised | 2010/11 Estimated | 2011/12 Estimated | 2012/13 Estimated |
|---|---|---|---|---|
| Non-HRA | 0.72% | (0.23%) | (0.63%) | (1.55%) |
| HRA | (0.19%) | (0.36%) | (0.58%) | (1.09%) |

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

19. **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.

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

| £ | Original 2009/10 | Forward Projection 2010/11 | Forward Projection 2011/12 | Forward Projection 2012/13 |
|---|---|---|---|---|
| Council Tax - Band D | 0.00 | 1.27 | (0.58) | 2.20 |

21. **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.

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

| £ | Original 2009/10 | Forward Projection 2010/11 | Forward Projection 2011/12 | Forward Projection 2012/13 |
|---|---|---|---|---|
| Weekly Housing Rent levels | 0.00 | 295.61 | (16.71) | 826.97 |

23. This indicator shows the revenue impact on any newly approved schemes if there was no rent restructuring in place. However, there is no actual impact on rent levels through any decisions on capital investments due the operation of rent restructuring currently.

**Treasury Management Strategy 2010/11 – 2012/13**

1. The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators in Annex 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 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). This Council adopted the Code of Practice on Treasury Management on 23 June 2004, and will adopt the revised Code.
3. As a result of adopting the Code the Council also adopted a Treasury Management Policy Statement (23 June 2004). This adoption is the requirements of one of the prudential indicators. However the revised Code of Practice has amended the Treasury Management Policy Statement and this is appended at Annex B3 for approval
4. 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 reports are produced after the year-end to report on actual activity for the year as was in year reporting of at least half-yearly.
5. This strategy covers:
    1. The Council's debt and investment projections;
    2. The Council's estimates and limits on future debt levels;
    3. The expected movement in interest rates;
    4. The Council's borrowing and investment strategies;
    5. Treasury performance indicators; and
    6. Specific limits on treasury activities.

**Debt and Investment Projections 2010/11 – 2012/13**

6. The borrowing requirement comprises the expected movement in the CFR and any maturing debt which will need to be re-financed. The table below shows this effect on the treasury position over the next three years. The expected maximum debt position during each year represents the Operational Boundary prudential indicator, and so may be different from the year end position. The table also highlights the expected change in investment balances

| £m | 2009/10 Revised £ | 2010/11 Estimated £ | 2011/12 Estimated £ | 2012/13 Estimated £ |
|---|---|---|---|---|
| External Debt | | | | |
| Debt at 1 April | (6.000m) | (4.000m) | (2.597m) | (2.576m) |
| Expected change in debt | 2.000m | 1.403m | 0.021m | 0.021m |
| Debt at 31 March | (4.000m) | (2.597m) | (2.576m) | (2.555m) |
| Operational Boundary | 4.000m | 3.000m | 3.000m | 3.000m |
| | | | | |
| Total Investments at 31 March | **26.903m** | **21.048m** | **18.635m** | **16.808m** |
| Investment change | 2.636m | 5.855m | 2.413m | 1.827m |

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

| £m | 2009/10 Revised £ | 2010/11 Estimated £ | 2011/12 Estimated £ | 2012/13 Estimated £ |
|---|---|---|---|---|
| Revenue Budgets | | | | |
| Interest on Borrowing | 0.398m | 0.322m | 0.277m | 0.292m |
| Related HRA Charge | (0.150m) | (0.130m) | (0.125m) | (0.140m) |
| Net General Fund Borrowing Cost | 0.248m | 0.192m | 0.152m | 0.152m |
| Investment income | 0.326m | 0.437m | 0.509m | 0.854m |

**Limits to Borrowing Activity**

8. Within the prudential indicators there are a number of key indicators to ensure the Council operates its activities within well defined limits
9. For the first of these the Council needs to ensure that its total borrowing net of any investments, does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2010/11 and the following two financial years (the relevant comparative figures are highlighted). This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

| £m | 2009/10 Revised | 2010/11 Estimate | 2011/12 Estimate | 2012/13 Estimate |
|---|---|---|---|---|
| Gross Borrowing | 4.000m | 2.597m | 2.576m | 2.555m |
| Investments | (25.343m) | (19.488m) | (17.075m) | (15.248m) |
| Net Borrowing | **(21.343m)** | **(16.891m)** | **(14.499m)** | **(12.693m)** |
| CFR* | **7.042m** | **6.965m** | **6.773m** | **6.588m** |

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

10. The Corporate Head of Finance and Customer Services reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

11. The Authorised Limit for External Debt – A further key prudential indicator represents a control on the overall level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

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

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

| Authorised limit £m | 2009/10 Revised | 2010/11 Estimate | 2011/12 Estimate | 2012/13 Estimate |
|---|---|---|---|---|
| Borrowing | **18.000m** | **18.000m** | **18.000m** | **18.000m** |
| Other long term liabilities | - | - | - | - |
| Total | **18.000m** | **18.000m** | **18.000m** | **18.000m** |

- Borrowing in advance of need – The Council has some flexibility to borrow funds this year for use in future years. The Corporate Head of Finance and Customer Services 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 Corporate Head of Finance and Customer Services 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

- Would not look to borrow more than 24 months in advance of need.

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

**Expected Movement in Interest Rates**

Medium-Term Rate Estimates (averages)

| Annual Average % | Bank Rate | Money Rates | | PWLB Rates* | | |
|---|---|---|---|---|---|---|
| | | 3 month | 1 year | 5 year | 20 year | 50 year |
| **2008/09** | **3.9** | **5.0** | **5.3** | **4.2** | **4.8** | **4.5** |
| **2009/10** | **0.5** | **0.8** | **1.4** | **3.2** | **4.4** | **4.6** |
| **2010/11** | **1.0** | **1.5** | **2.3** | **4.0** | **5.0** | **5.2** |
| **2011/12** | **2.0** | **2.5** | **3.3** | **4.3** | **5.3** | **5.3** |
| **2012/13** | **4.5** | **4.8** | **5.3** | **5.3** | **5.5** | **5.3** |

*** Borrowing Rates**

15. Short-term rates are expected to remain low for a considerable time. The recovery in the economy has commenced but it will remain insipid and there is a danger that early reversal of monetary ease, could trigger a dip back to negative growth.

16. Credit extension to the corporate and personal sectors has improved modestly but banks remain nervous about the viability of counterparties.

17. The main drag upon the economy is expected to be weak consumers' expenditure growth. The combination of the desire to reduce the level of personal debt and job uncertainty is likely to weigh heavily upon spending. This will be amplified by the prospective increases in taxation already scheduled for 2010 – VAT and National Insurance. Without a rebound in this key element of UK GDP growth, any recovery in the economy is set to be weak and protracted.

18. With inflation set to remain subdued in the next few years, the pressure upon the MPC to hike rates will remain moderate. But some increase will be seen as necessary in 2010 to counter the effects of external cost pressures (as commodity prices begin to rise again) and to avoid damage that sterling could endure if the UK is seen to defy an international move to commence policy exit strategies.

**Borrowing Strategy 2010/11 – 2012/13**

19. 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.

20. Long-term fixed interest rates are expected to be higher over the medium term and short term rates are expected to rise, although more modestly. The Corporate Head of Finance and Customer Services, 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.

21. With the likelihood of long term rates increasing, debt restructuring is likely to focus on switching from longer term fixed rates to cheaper short term debt, although the Corporate Head of Finance and Customer Services will monitor prevailing rates for any opportunities during the year.

22. The option of postponing borrowing and running down investment balances will also be considered. This would reduce counterparty risk and hedge against the expected fall in investments returns.

**Investment Strategy 2010/11 – 2012/13**

23. **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.

24. **Risk Benchmarking –** A development in the revised Codes and the CLG consultation paper 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.

25. These benchmarks are simple targets (not limits) 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 depending on any changes. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.

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

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

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

    - Bank overdraft - £0.25m
    - Liquid short term deposits of at least £3m available with a week's notice.
    - Weighted Average Life benchmark is expected to be 0.25 years, with a maximum of 1 years.

28. **Yield - Local measures of yield benchmarks are :**

    - Investments – Internal returns above the 7 day LIBID rate
    - Investments – External fund managers - returns 10% above 7 day compounded LIBID.

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

| | 1 year | 2 years | 3 years | 4 years | 5 years |
|---|---|---|---|---|---|
| **Maximum** | **0.006%** | **0.006%** | **0.0%** | **0.0%** | **0.0%** |

Note: This benchmark is an average risk of default measure (potential loss on investments), and would not constitute an actual 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 Corporate Head of Finance and Customer Services will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to either Council or Governance and Audit 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.

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 (where rated). 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.

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

- **Banks & Building Societies** – the Council will use a criteria based system covering Banks & Building Societies. (see Annex C for specific criteria).
- The UK Government (such as the Debt Management Account deposit facility, UK Treasury Bills or a Gilt with less than one year to maturity)
- A local authority
- Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency.

The proposed criteria for Specified and Non-Specified investments are shown in Annex C 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 only be used where the Council's liquidity requirements are safeguarded. This will also be limited by the investment prudential indicator below

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

36. **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-2010. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts.

37. There is an operational difficulty arising from the previous banking crisis. There is currently little value investing longer term unless credit quality is reduced. Whilst some selective options do provide additional yield uncertainty over counterparty creditworthiness suggests shorter dated investments would provide better security.

38. 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 Corporate Head of Finance and Customer Services 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.

39. 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, guaranteed deposit facilities and strongly rated institutions offered support by the UK Government. The credit criteria have been amended to reflect these facilities.

**Sensitivity to Interest Rate Movements**

40. 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 | 2010/11 Estimated + 1% | 2010/11 Estimated - 1% |
|---|---|---|
| Revenue Budgets | | |
| **Interest on Borrowing** | 0.322m | 0.322m |
| **Related HRA Charge** | (0.130m) | (0.130m) |
| **Net General Fund Borrowing Cost** | 0.192m | 0.192m |
| **Investment income** | **0.225m** | **(0.114m)** |

**Treasury Management Limits on Activity**

41. 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.

42. **The Council is asked to approve the limits:**

| £m | 2010/11 | 2011/12 | 2012/13 |
|---|---|---|---|
| Interest rate Exposures | | | |
| | Upper | Upper | Upper |
| Limits on fixed interest rates based on net debt | **7.000m** | **7.000m** | **7.000m** |
| Limits on variable interest rates based on net debt | **2.000m** | **2.000m** | **2.000m** |
| *Limits on fixed interest rates:* | | | |
| • *Debt only* | *100%* | *100%* | *100%* |
| • *Investments only* | *100%* | *100%* | *100%* |
| *Limits on variable interest rates* | | | |
| • *Debt only* | *30%* | *30%* | *30%* |
| • *Investments only* | *30%* | *30%* | *30%* |
| Maturity Structure of fixed interest rate borrowing 2010/11 | | | |
| | | Lower | Upper |
| Under 12 months | | 0% | **30%** |
| 12 months to 2 years | | 0% | **40%** |
| 2 years to 5 years | | 0% | **60%** |
| 5 years to 10 years | | 0% | **75%** |
| 10 years and above | | 0% | **100%** |
| Maximum principal sums invested > 364 days | | | |
| Principal sums invested > 364 days | **£12m** | **£8m** | **£5m** |

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

**Performance Indicators**

43. 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 (London Interbank Bid Rate)
- Investments – External fund managers - returns 110% above 7 day compounded LIBID.

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

**Treasury Management Advisers**

44. The Council uses Butlers as its treasury management advisers. 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;
45. 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**

46. 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:
    1. Carrying out specific Treasury Management training with the members of the Governance and Audit Committee
    2. Treasury Management officer has signed up to the new CIPFA treasury management qualification – Certificate in Treasury Management (Public Finance)
    3. Improved Governance arrangements through quarterly performance reports, annual report and midyear strategy revisions had aided the development and knowledge of committee members.

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

CLG issued Investment Guidance on 12th March 2004, and this forms the structure of the Council's policy below. The CLG is currently consulting over revisions to the Guidance and where applicable the Consultation recommendations have been included within this policy. These guidelines do not apply to either trust funds or pension funds which are under a different regulatory regime.

The key intention of the Guidance is to maintain the current requirement for Councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council adopted the Code on 23 June 2004 and will apply its principles to all investment activity. In accordance with the Code, the Corporate Head of Finance and Customer Services 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 the 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**.**

The criteria enable the Council to choose Specified and Non Specified investments. The rating criteria is based on the Lowest Common Denominator method (LCD - this includes ratings by Standard and Poor's, Moody's and Fitch) and institutions must meet all criteria (where rated) in order for the Council to place investments with them.

**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 low risk assets where the possibility of loss of principal or investment income is small. The Council's Treasury Management Officer is restricted to placing Specified Investment funds with:

<table>
<tr><th></th><th>Specified Investments Category</th><th>Limit</th></tr>
<tr><td>a</td><td>A body of high credit quality, this category includes the following -<br>□ A UK bank or building society awarded a high credit rating by a credit rating agency, meeting the following criteria using the LCD method
<table>
<tr><td colspan="4">Fitch</td><td colspan="3">Moody's</td><td colspan="2">Standard and Poor's</td></tr>
<tr><td>Short Term</td><td>Long Term</td><td>Individual</td><td>Support</td><td>Short Term</td><td>Long Term</td><td>Financial Strength</td><td>Short Term</td><td>Long Term</td></tr>
<tr><td>F1</td><td>AA-</td><td>C</td><td>3</td><td>P1</td><td>Aa3</td><td>C</td><td>A-1</td><td>AA-</td></tr>
</table>
□ A body of high credit quality by being an Eligible Institution under the UK Government's Asset protection scheme, and with minimum criteria of F1, A+ and equivalent from Moody's and Standard & Poor's using the LCD method.<br>□ A body of high credit quality by being under the UK government guarantee.</td><td>£5m per institution, £5m per corporate group</td></tr>
<tr><td>b</td><td>The UK Government (such as the Debt Management Account deposit facility, UK Treasury Bills or a Gilt with less than one year to maturity)</td><td>no amount limit</td></tr>
<tr><td>c</td><td>UK local authorities</td><td>£5m per LA, £10m all LAs</td></tr>
<tr><td>d</td><td>Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. This category covers pooled investment vehicles, such as money market funds, rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.<br>CLG Investment Guidance specifies that Money Market Funds with high credit ratings are classified as Specified Investment. These funds are instant access investment. There is possibility that part of the investment may be exposed to counterparties the Council would not approve normally or invest directly. The counterparty risk is mitigated by that –<ul><li>The Fund Managers diversify investment in a range of counterparties;</li><li>The Funds are instant access;</li><li>The Council only invests in funds rated AAA;</li><li>DCLG Investment Guidance classifying such funds as Specified Investment.</li></ul></td><td>£5m per fund, £10m all funds</td></tr>
</table>

**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:

Amounts invested with any one institution shall not exceed £2m for periods of more than 2 years. Amounts invested with any one corporate group shall not exceed £5m.

Amounts invested in non specified fixed term investment would normally not exceed 25% of total funds placed in fixed term deposit. The Corporate Head of Finance and Customer Service has the discretion to exceed the limit within reasons. If these circumstances are required this will be reported back to the appropriate committee.

| | **Non Specified Investment Category** | **Limit** |
|---|---|---|
| **a.** | **Any institutions meeting the criteria set out for Specified Investments,** with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment). | £2m maximum of 2 years per institution |
| **b.** | **Councils Bank –** Should its rating fall below that required for specified investment, monies will be restricted to instant access. | £7m |
| **c.** | **Top 10 building societies, by asset value.** | £2m, 2 years per institution, £5m for all B/S sector, |

**The Monitoring Investment Counterparties -** The credit rating of counterparties will be monitored regularly. The Council receives credit rating advice from its advisers, Butlers, on a daily basis and 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 Corporate Head of Finance and Customer Services, and if required new counterparties which meet the criteria will be added to the list.

Investments for periods exceeding 364 days limited to 25% of Fixed Term Deposit fund held, and forward commitment investments limited to 25% of Fixed Term Deposit fund held; and Notice Accounts are classified as Fixed Term Deposit before the notice expires.

**Use of External Fund Managers –**The Council currently uses external fund managers for part of its investment portfolio. The Council is not restricted to placing funds with cash managers, and will manage funds in house, use fund managers, or brokers if it is appropriate to do so.
The fund managers will use both specified and non-specified investment categories, and are contractually committed to keep to the Council's investment strategy. Currently the Council has an agreement with Tradition UK and Sterling International. The fund managers are required to adhere to the following:

- All investments restricted to sterling denominated instruments;
- Amounts invested with any one institution or Corporate Group should not exceed the limits specified in Table A and Table B.
- Portfolio management is measured against the return provided by the 3 month sterling LIBID, or in accordance with the measures specified in the contract.

The performance of investment managed by Fund Managers is reviewed at least quarterly by the Corporate Head of Finance and Customer Services.

**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
- Investments – External fund managers - returns 10% above 7 day compounded LIBID.

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 - £0.25m
- 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 1 years, with a maximum of 2 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 long term rating category over the period 1990 to 2007.

| Long term rating | 1 year | 2 years | 3 years | 4 years | 5 years |
|---|---|---|---|---|---|
| **AAA** | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| **AA** | 0.00% | 0.00% | 0.00% | 0.03% | 0.06% |
| **A** | 0.03% | 0.15% | 0.30% | 0.44% | 0.65% |
| **BBB** | 0.24% | 0.78% | 1.48% | 2.24% | 3.11% |

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 0.03% 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:

- 0.1% 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** | **0.03%** | **0.12%** | **0.10%** | **0.08%** | **0.06%** |

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.

Treasury Management Clauses to form part of Standing Orders/Financial Regulations/Constitution

1. This Council will create and maintain, as the cornerstones for effective treasury management:
   - A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities;
   - Suitable TMPs, setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.
2. The Council will receive reports on its treasury management policies, practices and activities, including as a minimum, an annual strategy and plan in advance of the year, a mid year review and an annual report after its close, in the form prescribed in its TMPs.
3. The Council delegates responsibility for the implementation and monitoring of its treasury management policies and practices to the Governance and Audit Committee, and for the execution and administration of treasury management decisions to the Corporate Head of Finance and Customer Services, who will act in accordance with the Council's policy statement and TMPs and CIPFA's Standard of Professional Practice on Treasury Management.
4. The organisation nominates the Governance and Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

**Risk Management** – The Council undertakes risk assessment for all fixed term deposits. The risk assessment uses the following template –

**Risk assessment of new investment (last updated August 2009)**

| **Investment** | **Institution** |
|---|---|
| Investment Product | Institution name |
| Principal Value | Eligibility |
| Term | Limit with this institution |
| Rate | Existing investment value |
| Rate % | Value inc new investment |
| Internal Reference | Is it within the limit? |

**Risk Assessment**

*Risk of the counterparty defaulting on investment*

| | | *Likelihood* | |
|---|---|---|---|
| | Counterparty on our specified list: Instant access | 1.4 | |
| | Counterparty only on non specified list: Instant access | 1.7 | |
| | Counterparty on our specified list: <=364 days | 2 | Unlikely |
| | Counterparty only on non specified list: <=364 days | 2.4 | |
| | Counterparty only on non specified list: >364 days | 3 | Likely |

| | *Impact of losing the investment* | *Impact* | |
|---|---|---|---|
| | Total principal less than £700,000 | 1 | Negligible |
| | Total principal between £700,000 and £1.4m | 2 | Minor |
| | Total principal between 1.4m and £3.5m | 3 | Major |
| | Total principal greater than £3.5m | 4 | Critical |

***Risk Score :***

Risk assessed by:

Risk assessment date: