AGENDA
ITEM 6

Report to: Audit Committee

Date of Meeting: 16th March 2011

Report of: Head of Strategic Finance

Title: Treasury Management Strategy and Treasury Management Practices for 2011/12

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1. SUMMARY

1.1. This report sets out for members the Council's proposed Treasury Management Strategy for 2011/12 together with details on Treasury Management Practices.

2. RECOMMENDATIONS

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

2.2.1 The Prudential Indicators and Limits for 2011/12 to 2013/14 contained within Appendix A of the report, including the Authorised Limit Prudential Indicator.

2.2.2 The Minimum Revenue Provision (MRP) Statement contained within Appendix A which sets out the Council's policy on MRP.

2.2.3 The Treasury Management Strategy 2011/12 to 2013/14, and the treasury Prudential Indicators contained within Appendix B.

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

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Report approved by: Head of Strategic Finance

3. DETAILS

3.1 These are all detailed within the Strategy attached at **Appendix 1**.

4. IMPLICATIONS

4.1 Financial

4.1.1. The Head of Strategic Finance comments that there are no direct financial implications arising out of this report.

4.2 Legal Issues (Monitoring Officer)

4.2.1 The Head of Legal and Property Services comments that It is a statutory requirement that the
Treasury Management Strategy and Treasury Management Practices are reviewed annually by the Audit Committee and Full Council.

4.3 Potential Risks

4.3.1 Audit Committee and Full Council need to regulate the borrowing and investment strategies carried out by officers in order to ensure all financial risk is minimised.

Background papers:
None

File Reference:
None

TREASURY MANAGEMENT STRATEGY REPORT 2011/12 – 2013/14
APPENDIX 1

Introduction

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

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

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

Appendix A

The Capital Prudential Indicators 2011/12 – 2013/14

Introduction

The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected capital activity or introduces limits upon that activity, reflecting the outcome of the Council's underlying capital appraisal systems. This report updates currently approved indicators.

Within this overall prudential framework there is an impact on the Council's treasury management activity – as it will directly impact on borrowing or investment activity. As a consequence the treasury management strategy for 20011/12 to 2013/14 is included as Appendix B to complement these indicators. Some of the prudential indicators are shown in the treasury management strategy to aid understanding.

1 Capital Expenditure Plans

The Council's capital expenditure plans were summarised within the Draft Revenue and Capital Estimates Report (Appendix 10) approved by Cabinet and Council on 17th January and 26th January and form 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);
- Practicality (e.g. the achievability of the forward plan).

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

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

The key risks to the plans are that the level of Government support has been estimated and is therefore maybe subject to change. Similarly some estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale. For instance anticipated asset sales may be postponed due to the poor condition of the property market.

Approving capital expenditure plans is the first prudential indicator.

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

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

Council's underlying borrowing need. The capital expenditure above which has not immediately been paid for will increase the CFR.

The Council has no net financing need as a result of the capital expenditure plans up to 2013/14.

Following accounting changes the CFR includes any other long term liabilities (e.g. PFI schemes) brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for this scheme. The Council currently has no such schemes within the CFR.

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					
Total CFR	**3.0**	**3.0**	**3.0**	**3.0**	**3.0**
Adjustment A	**3.1**	**3.1**	**3.1**	**3.1**	**3.1**
Movement in CFR	**0**	**0**	**0**	**0**	**0**

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

Watford Council's approach has been to comply with the previous MRP regulations which allowed for an adjustment A which allowed debt free authorities to continue to not make an MRP. Any new capital expenditure if unfunded and requiring credit cover above adjustment A would need to generate a MRP.

3 Minimum Revenue Provision Statement

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

The Council has no debt and a zero adjusted Capital Financing Requirement, so will not be making a Minimum Revenue Provision.

However, for unsupported borrowing as a result of Finance Leases, the MRP policy will be either:

- **Asset Life Method** – MRP will be based on the estimated life of the assets, in accordance with the proposed regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction) (Option 3); or
- **Depreciation method** – MRP will follow standard depreciation accounting procedures (Option 4);

These options provide for a reduction in the borrowing need over approximately the asset's life.

Watford made a voluntary MRP for finance leases in 2008-09 and will continue to do so for new finance leases under option 3 of the revised guidance based on asset life.

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

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed cash flow balances are produced and regularly reviewed by the Treasury Management Officer and are vital information in determining a maturity schedule for the council's investments. Year end balances for capital resources are considered elsewhere with capital priorities.

5 Affordability Prudential Indicators

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

6 Actual and Estimates of the ratio of financing costs to net revenue stream

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. As the council is debt-free and has a zero adjusted CFR, this indicator is not applicable.

7 Estimates of the incremental impact of capital investment decisions on the Council Tax

This indicator identifies the revenue costs associated with *proposed changes* to the three year capital programme recommended to Cabinet and Council in January when compared to the Council's existing approved commitments and current plans. The assumptions will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

The changes were given in detail at Appendix 10 to the Draft Revenue and Capital Estimates 2011-15 approved by Cabinet and Council in January 2011.

Appendix B

Treasury Management Strategy 2011/12 – 2013/14

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. .

The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). This Council has adopted the Code of Practice on Treasury Management.

As a result of adopting the Code the Council also adopted a Treasury Management Policy Statement. This adoption is the requirements of one of the prudential indicators.

The Constitution requires a 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. A new requirement of the revision to the Code of Practice requires a mid-year monitoring report.

This strategy covers:

- The Council's debt and investment projections;
- The Council's estimates and limits on future debt levels(borrowing activity);
- The expected movement in interest rates;
- The Council's borrowing and investment strategies;
- Specific limits on treasury activities;
- Treasury performance indicators;
- Treasury Advice
- Training of Officers and Members

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

The borrowing requirement comprises the expected movement in the Capital Financing Requirement (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

Operational Boundary

Short-term borrowing (up to one year) is permitted for debt-free authorities. The expected maximum debt position during each year represents the Operational Boundary prudential indicator. The table below also highlights the expected change in investment balances.

	2010/11 Revised £m	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m
External Debt	**N/A**			
Operational Boundary	**5**	**5**	**5**	**5**

Investments				
Total Investments at 31 March	25	17	11	9
Investment change		8	6	2

The related impact of the above movements on the revenue budgets are:

	2010/11 Revised £m	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m
Revenue Budgets				
Interest on Borrowing	0	0	0	0
Investment income	0.496	0.346	0.326	0.300

2 Limits to Borrowing Activity

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

For the first of these the Council needs to ensure that its total borrowing net of any investments, does not, except in the short term, exceed the total of the Capital Financing Requirement 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.

	2010/11 Revised £m	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m
External Loans (long term)	0	0	0	0
Plus Other long term liabilities	0	0	0	0
Gross Borrowing	0	0	0	0
Less Investments	-25	-17	-11	-9
Net Borrowing	-25	-17	-11	-9
CFR	0	0	0	0

The Head of Strategic 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 all proposals within the Detailed Revenue and Capital Estimates report.

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

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.

The Council is asked to approve the following Authorised Limit:

Authorised limit	2010/11	2011/12	2012/13	2013/14

	Revised £m	Estimat e £m	Estimat e £m	Estimat e £m
Borrowing	7	7	7	7
Other long term liabilities	0	0	0	0
Total	7	7	7	7

3 Expected Movement in Interest Rates

Medium-Term Rate Estimates (averages January 2011)

The Council's treasury adviser, Sector, provides the following forecast and commentary:

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

There is significant uncertainty with economic forecasts. Whilst short-term rates are expected to remain on hold through most of 2011, inflationary concerns are increasing. Inflation has been above the 2% target for so long the credibility of the MPC may become a greater focus. This will make the MPC's decisions during 2011 a difficult judgment; control inflation or continue to aid the recovery? The MPC will be particularly concerned that the public's inflation expectations could feed through into a demand for pay award increases. There is a risk that the MPC may feel they will need to take action earlier than originally anticipated, i.e.Q2, in order to reinforce its credibility.

The recovery in the economy is 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 particularly following the recent VAT increase. 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.

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

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

Eventually, the absence of the Bank of England as 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.

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.

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

4 Borrowing Strategy 2011/12 – 2013/14

The Council became debt-free during the financial year 2000/01 and it is anticipated that there will be no capital borrowing during the next three years.

5 Investment Strategy 2011/12 – 2013/14

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

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.

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

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

- 0.01% historic risk of default when compared to the whole portfolio.

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

- Bank overdraft - £0.5m
- Liquid short term deposits of at least £2m available with a week's notice.
- Weighted Average Life benchmark is expected to be 0.5years, with a maximum of 10 years for an individual loan with a public body.

Yield - Local measures of yield benchmark is (Performance Indicator):

- Investments – returns 0.12% above average bank rate

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

	1 year	2 years	3 years	4 years	5 years
Maximum	0.01%	N/A	N/A	N/A	N/A

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

Investment Counterparty Selection Criteria

The Council will ensure:

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

The Head of Strategic 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.

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, then the institution will fall outside the lending criteria. This is in compliance with a CIPFA Treasury Management Panel recommendation in March 2009 and the CIPFA Treasury Management Code of Practice.

Credit rating information is supplied by our treasury consultants on all active counterparties that comply with the Council's criteria. 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 criterion will be suspended from use, with all others being reviewed in light of market conditions.

Counterparty Categories

The Council uses the following criteria in choosing the categories of institutions in which to invest:

- **Banks 1 - Good Credit Quality**
  The Council will only use banks which meet the Rating criteria given in the table below
- **Banks 2 – Eligible Institutions**
  The Council will use organisations considered an Eligible Institution for the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008, with the necessary short and long term ratings required in Banks 1 above.
- **Banks 3 – The Council's own banker**
  For transactional purposes, if the bank falls below the above criteria, it will be included, although in this case balances will be minimised in both monetary size and time within operational constraints.
- **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:

  either
  i. meet the ratings for banks outlined above
  or
  ii. are eligible Institutions; and have assets in excess of limits for each category
- **Specific Public Bodies**
  The Council may lend to Public Bodies other than Local Authorities. The criterion for lending to these bodies is that the loan has been approved by Full Council.
- **Local Authorities**

  A limit of 10% will be applied to the use of Non-Specified investments.
- **Money Market Funds having a triple AAA credit rating**
- **Collateralised Deposits**

  A new product developed by RBS specifically for Local Authority clients based upon Local Authority requirements to optimise the returns achieved on deposited reserve backed cash balances whilst at the same ensuring capital preservation. The minimum amount that can be placed with RBS under the Collateralised Deposit product is £5m, and the minimum term is 1 year. Whilst Watford has no intention to use these instruments at the present time, they should be included as a potential future option within this Treasury Strategy Report.
- **Government Debt Management Office (DMO) Account**

  Debt Management Account Deposit Facility (DMADF)

  The DMO provides the DMADF as part of its cash management operations and in the context of a wider series of measures designed to support local authorities' cash management. The key objective of the DMADF is to provide users with a flexible and secure facility to supplement their existing range of investment options while saving interest costs for central government.

  The DMADF currently offers fixed term deposits. All deposits taken will be placed in, and interest paid from, the Debt Management Account. All deposits will be also guaranteed by HM Government and therefore have the equivalent of a sovereign triple-A credit rating.

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.

Use of additional information other than credit ratings
Additional requirements under the Code of Practice require the Council to supplement credit rating information. Whilst the above criteria rely 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.

Time and Monetary Limits applying to Investments

The time and monetary limits for institutions on the Council's Counterparty List summarised in the table below, are driven by the above criteria. These limits will cover both Specified and Non-Specified Investments.

Institution Type	Max Amount:			£2m	£5m	£5m	£5m	£5m
	Max Length:			10 Years	364 Days	6 Months	3 Months	1 Month
	Minimum Short Term Ratings							
	Fitch	Moody's	S&P					
UK Banks								
Banks with Clearing Status in the United Kingdom	F1	P-1	A-1		Backed up by AA(F), Aa2(M) and AA(S&P) long term credit rating	Backed up by single A long term ratings by all agencies	Backed up by lower than A long term rating	
The Council's own Bankers or National Westminster	F1	P-1	A-1	A limit of £10m is permissible for short term deposits (less than 1 month). If Council's own bankers fall below the minimum long term criteria for UK banks, cash balances will be managed within operational liquidity constraints				
Wholly Owned Subsidiaries of UK Clearing Banks - Parent Ratings	F1	P-1	A-1		Backed up by AA(F), Aa2(M) and AA(S&P) long term credit rating	Backed up by single A long term ratings by all agencies	Backed up by lower than A long term rating	
UK Building Societies								
Either	F1	P-1	A-1		Backed up by AA(F), Aa2(M) and AA(S&P) long term credit rating	Backed up by single A long term ratings by all agencies	Backed up by lower than A long term rating	
Or					Assets over £15,000m	Assets over £5,000m	Assets of £2,500m	Assets over £1,000m

Specific Public Bodies				As approved by Members				
UK Local Authorities				The Council can invest in all UK Local Authorities whether rated or not				
Money Market Funds				£5m				
Collateralised Deposits				£5m				
Debt Management Account Deposit Facility				£10m				

Notes

1 F1+, P-1 and A-1+ are the highest short term credit ratings of Fitch, Moody's and Standard and Poor's respectively

2 Minimum Short Term Ratings - Where given, these must be met, for all categories

3 Building Societies - A Building Society has to meet either the ratings criteria or the assets criterion to be included in the category, not both

4 Maximum amount is the maximum, in total, over all investments, with any one institution

The proposed criteria for Specified and Non-Specified investments are shown in Annex B1 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 longer term investment limits.

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 mid2011. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts.

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

Sensitivity to Interest Rate Movements

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

	2011/12 Estimated + 1%	**2011/12 Estimated - 1%**

	£m	£m
Revenue Budgets		
Interest on Borrowing	N/A	N/A
Net General Fund Borrowing Cost	N/A	N/A
Investment income	0.210	-0.210

6 Treasury Management Limits on Activity

There are four further treasury activity limits, which were previously prudential indicators. The purpose of these are to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. The indicators are:

- Upper limits on variable and fixed interest rate exposure – These identify maximum limits for variable and fixed interest rates based upon the debt position net of investments. The council is debt-free, so has no interest rate exposure on long term debt.
- Upper limit on variable interest rate exposure – Short-term borrowing. The majority of short-term borrowing is likely to be bank overdraft.
- Maturity structures of borrowing – N/A.
- Total principal funds invested for greater than 364 days – These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The Council is asked to approve the limits:

£m	2011/12	2012/13	2013/14
Interest rate Exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	N/A	N/A	N/A
Limits on variable interest rates based on net debt	N/A	N/A	N/A
Maturity Structure of fixed interest rate borrowing 2011/12 – N/A			
Maximum principal sums invested > 364 days			
Principal sums invested > 364 days	£2m	£2m	£2m

7 Performance Indicators

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

- Investments – returns 0.12% above average bank rate and reinforces the primacy of 'security' of the investment

The results of this indicator will be reported in the Treasury Annual Report.

8 Treasury Management Advisers

The Council uses Sector as its treasury management consultants. The company provides a range of services which include:

- Technical support on treasury matters, capital finance issues and the drafting of Member reports;
- Economic and interest rate analysis;
- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings/market information service comprising the three main credit rating agencies;

Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remains with the Council. This service is subject to regular review.

9 Member and Officer Training

The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for Members and officers. This Council has addressed this important issue by:

- Ensuring that officers attend suitable courses and seminars to keep their technical knowledge up to date
- Keeping up to date with CIPFA publications on Treasury Management
- Regular briefings both by e mail and face to face with the Council's consultants
- Membership of the CIPFA Corporate Services Benchmarking Club for Treasury Management
- Reports and briefing sessions to Members on major changes to Treasury policies and strategies including an annual report to Audit Committee from the Council's advisers Sector.

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

Annual Investment Strategy - The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of following:

- The strategy guidelines for choosing and placing investments, particularly non-specified investments.
- The principles to be used to determine the maximum periods for which funds can be committed.
- Specified investments the Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
- Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

The investment policy proposed for the Council is:

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

Specified Investments – These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are considered low risk assets where the possibility of loss of principal or investment income is small. For the Council these are 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. A local authority, parish council or community council.

3. A body that is considered of a high credit quality, such as a bank or building society with a minimum short term rating of F-1 as rated by Fitch. (or the equivalent as rated by Standard and Poor's or Moody's) rating agencies or a Building Society with assets over £1,000m. Non-rated subsidiaries and non-rated building societies will need to be non-specified investments.

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. These criteria are defined in the Treasury Management Strategy.

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 (*the guidance does not specify sterling so its inclusion is optional for English authorities)* with:

	Non Specified Investment Category	**Limit (£ or %)**
a.	Any **bank or building society** that has a minimum long term credit rating of A (or equivalent), for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	**£2m or 10%**
b.	**The Council's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.**	**In this instance balances will be minimised as far as possible**
c.	**Building societies not meeting the basic security requirements under the specified investments**. The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings. The Council may use such building societies which were originally considered Eligible Institutions and have a minimum asset size of £1,500m, but will restrict these type of investments to £2m for one month	**£2m**
d.	**Specific Public Bodies** The Council can seek Member approval to make loans to other public bodies for periods of more than one year.	**£2m**
e.	**Other Local Authorities**	**£2m**

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 criteria are defined in the Treasury Management Strategy.

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

The Monitoring of Investment Counterparties

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

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. The Local measure of yield benchmark is:

- Investments – returns 0.12% above average bank rate

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

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

- Bank overdraft - £0.5m
- Liquid short term deposits of at least £2m available with a week's notice.

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

- WAL benchmark is expected to be 0.5 years, with a maximum of 10 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 "AA", meaning the average expectation of default for a one year investment in a counterparty with an "AA" 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 investments in rated institutions are all for periods of less than one year, so the average loss will be scaled down by the length of investment.

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

- 0.01% historic risk of default when compared to the whole portfolio.

As the Council has no investment in rated institutions for more than 364days, the security benchmark for more than one year is not applicable:

	1 year	2 years	3 years	4 years	5 years
Maximum	0.01%	N/A	N/A	N/A	N/A

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.