Report on the Council's Prudential Indicators for 2010/11 to 2012/13 and the Treasury Management Strategy for 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:

- The reporting of the **prudential indicators** setting out the expected capital activities;
- The Council's **Minimum Revenue Provision (MRP) Policy**, which sets out how the Council will pay for capital assets through revenue each year;
- The **treasury management strategy statement** which sets out how the Council's treasury service will support the capital decisions taken above;
- The **investment strategy** which sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss.

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

The main changes above increase the Members' responsibility in scrutiny of the treasury policies, increased Member training and awareness and greater frequency of information.

One element of the revised CIPFA Treasury Management Code of Practice is that the constitution is amended to identify the appropriate committee be responsible for ensuring effective scrutiny of the treasury management strategy and policies, before making recommendations to Council.

Recommendations;

1. **The Council is recommended to adopt the prudential indicators and limits for 2010/11 to 2012/13 contained within Annex 15a of the report. The main indicators are summarised in the table below:**

	2008/09 Actual	2009/10 Revised	2010/11 Estimate	2011/12 Estimate	2012/13 Estimate
Capital Expenditure	10,472	14,800	14,563	9,875	8,003
Capital financing requirement	-£0.784m	-£0.784m	-£0.784m	-£0.784m	-£0.784m
Ratio of financing costs to net revenue stream – General Fund	-10.37%	-3.18%	-2.52%	-3.23%	-6.27%
Ratio of financing costs to net revenue stream – HRA	-10.74%	-3.29%	-2.60%	-3.35%	-6.49%
Incremental impact of capital investment decisions on the Band D Council Tax	N/a	-£0.59	-£0.37	£0.51	£1.50
Incremental impact of capital investment decisions on weekly housing rents levels	N/a	£0.04	£0.11	-£0.61	-£2.51

2. **Members are recommended to approve the Council's Statement on the Minimum Revenue Provision contained within Annex 15a of the report.**

3. **Members are recommended to approve the treasury management strategy for 2010/11 to 2012/13 contained within Annex 15b. The treasury prudential indicators are set out in the tables below;**

	2008/09 Actual	**2009/10 Revised**	**2010/11 Estimate**	**2011/12 Estimate**	**2012/13 Estimate**
Authorised limit for external debt	£5.0m	£5.0m	£5.0m	£5.0m	£5.0m
Operational boundary for external debt	£0.5m	£0.5m	£0.5m	£0.5m	£0.5m

Exposure to fixed/variable interest rates	**2010/11 Upper**	**2011/12 Upper**	**2012/13 Upper**
Limits on fixed interest rates	100%	100%	100%
Limits on variable interest rates	30%	30%	30%

Maturity Structure of fixed interest rate borrowing						
	2010/11		**2011/12**		**2012/13**	
	Lower	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	0%	100%	0%	100%	0%	100%
12 months to 2 years	0%	0%	0%	0%	0%	0%
2 years to 5 years	0%	0%	0%	0%	0%	0%
5 years to 10 years	0%	0%	0%	0%	0%	0%
10 years and above	0%	0%	0%	0%	0%	0%
Maximum principal sums invested for 1 year or more	£30 m		£30 m		£30 m	
Investment returns to exceed the 7 day LIBID rate by;	0.10 %		0.10%		0.10%	

4. **Members are recommended to approve the investment strategy for 2010/11 contained in the treasury management strategy (Annex 15b), and the detailed criteria included within it, specifically approving:**
   - **The criteria for specified investments**
   - **The criteria for non-specified investments**

The Prudential Indicators 2010/11 – 2012/13

1. The Local Government Act 2003 required the Council to adopt the CIPFA Prudential Code and to 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 to 2012/13 and the treasury indicators form part of this report.

Capital Expenditure Plans

3. The first prudential indicators govern the Council's capital expenditure plans, its net borrowing position and its Capital Financing Requirement (CFR). The Council's capital expenditure plans are summarised below. Capital expenditure can be financed immediately (by resources such as contributions from revenue, capital receipts and capital grants), so that with no unfinanced expenditure there is no need to borrow.
4. A certain level of capital expenditure will be grant supported by the Government; anything above this level will be unsupported and will need to be paid for from the Council's own resources. The Government has the power to restrict the level of external debt undertaken by either all councils as a whole or of a specific council, although these powers have not yet been exercised.
5. The key risk to the plans is that the level of Government support has been estimated and is therefore subject to change. Similarly some of the estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale.
6. **The Council is recommended to approve the capital expenditure estimates presented in Table 1.**

Table 1: Estimated Capital Expenditure 2009/10 to 2012/13

Directorate	2008/09 Actual £'000	2009/10 Revised Estimate £'000	2010/11 Original Estimate £'000	2011/12 Original Estimate £'000	2012/13 Original Estimate £'000
Finance & ICT	431	418	661	300	300
Corporate Support Service	62	296	977	364	333
Deputy Chief Executive	134	254	3,341	450	0
Environment & Street Scene	461	2,997	1,018	820	133
Planning & Economic Development	932	1,535	0	0	0
Housing General Fund	1,779	1,157	1,610	930	920
Total General Fund	**3,799**	**6,657**	**7,607**	**2,864**	**1,686**
HRA	6,624	8,088	6,956	6,961	6,267
Housing DLO	49	55	0	50	50
Total Housing Revenue Account	**6,673**	**8,143**	**6,956**	**7,011**	**6,317**
TOTAL	**10,472**	**14,800**	**14,563**	**9,875**	**8,003**

The Council's Capital Financing Requirement

7. The Council's Capital Financing Requirement (CFR) is the total capital expenditure which has not yet been financed from either revenue contributions or capital income. It is essentially a measure of the Council's underlying borrowing need; any unfinanced capital expenditure will increase the Council's CFR. Table 2 demonstrates that all projected capital expenditure over the current and the next three financial years is expected to be financed, and that the Council's CFR is expected to remain unchanged.

8. **Members are asked to approve the Capital Financing Requirement from 2009/10 to 2012/13, contained within Table 2, which shows the Council has complied with keeping net borrowing below the appropriate CFR in 2008/09, and that no difficulties are envisaged for the financial years 2009/10 to 2012/13.**

Table 2: Capital Expenditure Financing and its effect on the CFR

	2008/09 Actual £'000	2009/10 Revised £'000	2010/11 Estimate £'000	2011/12 Estimate £'000	2012/13 Estimate £'000
Total General Fund	3,799	6,657	7,607	2,864	1,686
Financed by:					
Capital receipts	2,766	5,151	5,889	2,561	1,383
Capital grants	1,033	1,506	1,718	303	303
Revenue Contributions	0	0	0	0	0
Total Financed Expenditure	**3,799**	**6,657**	**7,607**	**2,864**	**1,686**
Net financing need for the year	**0**	**0**	**0**	**0**	**0**
Opening CFR	**22,019**	**22,019**	**22,019**	**22,019**	**22,019**
CFR arising during the year	**0**	**0**	**0**	**0**	**0**
Closing CFR	**22,019**	**22,019**	**22,019**	**22,019**	**22,019**
Total Housing Revenue Account	6,673	8,143	6,956	7,011	6,317
Financed by:					
Capital receipts	20	0	0	0	0
Capital grants	193	115	50	50	50
Revenue Contributions	6,460	8,028	6,906	6,961	6,267
Total Financed Expenditure	**6,673**	**8,143**	**6,956**	**7,011**	**6,317**
Net financing need for the year	**0**	**0**	**0**	**0**	**0**
Opening CFR	**-22,803**	**-22,803**	**-22,803**	**-22,803**	**-22,803**
CFR arising during the year	**0**	**0**	**0**	**0**	**0**
Closing CFR	**-22,803**	**-22,803**	**-22,803**	**-22,803**	**-22,803**
General Fund CFR	22,019	22,019	22,019	22,019	22,019
HRA CFR	-22,803	-22,803	-22,803	-22,803	-22,803
Total CFR	**-0.784**	**-0.784**	**-0.784**	**-0.784**	**-0.784**

9. Local authorities are required to repay an element of the accumulated General Fund capital spend – represented by the CFR - through an annual revenue charge (the Minimum Revenue Provision, or MRP).

10. CLG Regulations will require full Council to approve an MRP Statement. This will need to be approved in advance of each financial year. As the timetable for consultation is very tight, members are asked to approve the following MRP statement:

As the Council is currently debt-free and intends to remain so for the foreseeable future, there is no requirement to make a provision for external debt repayment. If the Council identifies a need to borrow externally, the Council will draw up a minimum revenue policy in accordance with proper accounting practice, and will present this to members for approval.

11. **Members are asked to approve the Council's Minimum Revenue Provision Statement, set out in paragraph 10 above.**

Affordability Prudential Indicators

12. The previous sections cover prudential indicators designed to examine capital expenditure and control of borrowing: prudential indicators in this section 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 financial affairs, and identify the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

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

14. Prudential Indicators for the actual and estimated ratios of financing costs to net revenue stream for the General Fund and Housing Revenue Accounts, and are shown in Table 3. As the Council is debt-free, these are based on investment income and are therefore negative.

Table 3: Actual and estimated ratios of financing Costs to net revenue stream

	2008/09 Actual %	2009/10 Revised Estimate %	2010/11 Estimated Forecast %	2011/12 Estimated Forecast %	2012/13 Estimated Forecast %
General Fund	-10.37	-3.18	-2.52	-3.23	-6.27
HRA	-10.74	-3.29	-2.60	-3.35	-6.49

15. Prudential Indicator for the estimate of the incremental impact of capital investment decisions on the Band D Council Tax over the next three financial years, and is shown in Table 4. This indicator identifies the revenue costs associated with new schemes introduced to the capital programme considered as Appendix 15 to this report, compared to the capital programme examined for the 2009/10 Prudential Indicators. The assumptions are based on the budget, but will invariably include some estimates, such as the level of government support in future years.

16. Prudential Indicator for the estimates of the incremental impact of capital investment decisions on housing rent levels over the next three financial years. Similar to the Council Tax calculation, this indicator identifies the trend in the cost of proposed changes in the part of the capital programme relating to the Housing Revenue Account. It compares the most recent programme to that examined for the 2009/10 Prudential Indicators, and is expressed as a discrete impact on weekly rent levels.

Table 4: Incremental impact of capital investment decisions on Council tax and rents				
	2009/10 Revised **£**	**2010/11 Estimate** **£**	**2011/12 Estimate** **£**	**2012/13 Estimate** **£**
Band D Council Tax	-0.59	-0.37	0.54	1.50
Housing rents levels	0.04	0.11	-0.61	-2.51

17. It should be emphasised that these are theoretical, and do not imply an actual requirement to raise either Council Tax or housing rent levels. Any move to raise housing rent levels will be constrained by the rent restructuring controls.

Treasury Management Strategy 2010/11 – 2012/13

18. The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators considered so far relate to the affordability and impact of capital expenditure decisions and govern 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 that the Council meets the "balanced budget" requirement under the Local Government Finance Act 1992. There are specific treasury prudential indicators included within this strategy which require approval.

19. 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 22 April 2002, and as a result formulated a Treasury Management Policy Statement (approved by Cabinet on 18 October 2004). However, the revised Code of Practice has amended the Treasury Management Policy Statement and is at Annex 15b (iii) for approval. This adoption meets the requirements of the first of the treasury prudential indicators.

20. The Council's Treasury Management policy requires an annual strategy to be reported to Council in advance of the first financial year to which it relates, outlining the expected treasury activity for the following three financial 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 within six months of the year-end to report on actual activity for the year, and a new requirement of the revision of the Code of Practice is that there is a mid-year monitoring report.

21. This strategy covers:

    - The Council's debt and investment projections;
    - The Council's estimates and limits on future debt levels;
    - The expected movement in interest rates;
    - The Council's borrowing and investment strategies;
    - Treasury performance indicators;
    - Specific limits on treasury activities;

Debt and Investment Projections 2010/11 – 2012/13

22. The borrowing requirement comprises the expected movement in the CFR and any maturing debt which will need to be re-financed. Table 5 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. It also highlights the expected change in investment balances, although as a matter of prudence it does not include an estimate for capital receipts from proposed land sales.

23. Although the Council is debt-free and expects to remain so for the foreseeable future, there is a reducing element of debt taken out on behalf of other local authorities. Epping Council has repaid the underlying external debt in full from its own resources; the authorities concerned are paying the Council their share of the debt plus interest in instalments. This is shown as negative debt, as it represents income to the Council.

Table 5: Estimated Treasury position as at 31 March, 2010 to 2013				
	2010 Revised £'000	**2011 Estimate £'000**	**2012 Estimate £'000**	**2013 Estimate £'000**
External Debt				
External debt	0	0	0	0
Less transferred debt	-507	-481	-452	-424
Total debt	**-507**	**-481**	**-452**	**-424**
Investments				
Investment portfolio	44,000	42,000	38,000	38,000
Funds held in short notice accounts	9,000	8,000	8,000	8,000
Total investments	**53,000**	**50,000**	**46,000**	**46,000**
Change from previous year	-4,250	-3,000	-4,000	0
Annual net interest income	1,120	899	1,137	2,198

Limits to Borrowing Activity

24. Within the Prudential Indicators there are a number of key indicators to ensure that the Council operates its external borrowing activities within well defined limits.

25. In order to comply with the first Prudential Indicator the Council must 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 2009/10 and next two financial years. This allows flexibility for limited early borrowing for future years.

26. The Director of Finance & ICT confirms that the Council has complied with this prudential indicator throughout the current year and does not envisage difficulties for the foreseeable future. This view takes into account current commitments, existing plans, and proposals contained within this budget report. The Council's estimated net debt positions as at 31 March 2010 and for the next three years are shown for information in Table 5.

27. The Authorised Limit for External Debt. This represents a limit beyond which external debt is prohibited, and needs to be approved by full Council. It reflects the level of external debt which 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.

28. The Operational Boundary for External Debt. This indicator is based on the expected maximum external debt during the course of the year; it is not a limit.

29. The Council became debt-free on 29th March 2004, and intends to remain debt-free for the foreseeable future, meaning that the Authorised Limit is unlikely to be breached. The Director of Finance & ICT confirms that the Council has remained within these two limits during the current year, and does not foresee any difficulty in continuing to do so.

30. **The Council is recommended to approve the Authorised Limit and Operational Boundary set out in Table 6.**

Table 6: The Authorised and Operational Limits of External Debt				
	2009/10 Revised £ m	**2010/11 Estimate £ m**	**2011/12 Estimate £ m**	**2012/13 Estimate £ m**
Authorised limit	5.0	5.0	5.0	5.0
Operational boundary	0.5	0.5	0.5	0.5

Borrowing in advance of need

31. The Council has some flexibility to borrow funds this year for use in future years to fund the approved capital programme, where there is a clear business case for doing so. However, the Council is debt free and expects to remain so for the foreseeable future.

Economic Forecast

Table 7: Expected movements in interest rates (Source: Butlers, January 2010)				
		Market investment rates		
As at end of:	**Base Rate %**	**3 month %**	**6 month %**	**12 month %**
December 2009	0.50	0.60	0.80	1.20
March 2010	0.50	0.70	0.90	1.50
June 2010	0.75	0.90	1.30	1.90
September 2010	1.00	1.20	1.50	2.20
December 2010	1.00	1.30	1.60	2.40
March 2011	1.25	1.50	1.80	2.60

32. Short-term rates are expected to remain on hold 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, (rate cuts and Quantative Easing {QE}), could trigger a dip back to negative growth and a W-shaped GDP path.

33. Credit extension to the corporate and personal sectors has improved modestly but banks remain nervous about the viability of counterparties. This is likely to remain a drag upon activity prospects, as will the lacklustre growth of broad money supply.

34. 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.

35. The MPC will continue to promote easy credit conditions via QE. QE has been extended to a total of £200bn and there is still an outside chance that it could be expanded further in February. Whether this has much impact in the near term remains a moot point given the personal sector's reluctance to take on more debt and add to its already unhealthy balance sheet.

36. 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.

37. Longer terms rates are expected to be more volatile. The current ‘softness’ of gilt yields & PWLB rates may continue for a while yet, given that these are being driven by a benign international backdrop and the effects of QE. Nevertheless this process will come to an end before the close of the financial year.

38. This is likely to herald a return to rising yields for a number of reasons:

- Net gilt issuance will rise sharply;
- This will be increased by the extent to which the BoE attempts to claw back funds injected to the economy via QE programme.
- Investors will be looking to place more if their funds in alternative instruments as their risk appetite increases, demand for gilts will weaken as a consequence;
- A decision to leave QE in place will generate inflation concerns and pressurise long yields higher.

Investment Strategy 2010/11 – 2012/13

39. The primary objectives of the Council’s investment strategy 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 maintains the controls already in place in the approved investment strategy.

40. A development in the revised Codes and the CLG consultation paper is the consideration and approval of security and liquidity benchmarks. 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 will be reported with supporting reasons in the Mid-Year or Annual Report.

41. Security – The Council’s maximum security risk benchmark for the current portfolio, when compared to historic default tables, is 0.03%

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

- 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.
- Bank overdraft – the Council has a facility in place to use, if necessary.
- Liquid short term deposit of at least £1.5M available with a weeks notice
- Weighted Average Life benchmark is expected to be 0.50 years, with a maximum of 0.60 years.

43. Yield – Local measures of yield benchmark is investment returns 0.10% above the 7 day LIBID rate.

Investment Counterparty Selection Criteria

44. 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 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.

- 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.

45. The Director of Finance & ICT will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. This criteria is separate to that which chooses Specified and Non-Specified investments as it selects which counterparties the Council will invest with rather than defining what form its investments will take. The rating criteria (see explanation of the credit ratings in Annex 15b (iii)) use the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria.

46. 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 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.

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

- **Banks and Building Societies** – the Council will invest in banks and building societies which have the following Fitch or equivalent ratings as a minimum:
  - **Short Term** – F1 (minimum of F1+ for total investments between £5m to £10m)
  - **Long Term** – A (minimum of AA- for total investments between £5m and £10m)
  - **Individual / Financial Strength** – C (Fitch / Moody's only)
  - **Support** – 3 (Fitch only)
- **Banks and Building Societies** – the Council will use banks and building societies whose ratings fall below the criteria specified above if all of the following are met:
  - Wholesale deposits in the bank are covered by a government guarantee;
  - The government providing the guarantee is rated "AAA".
  - The Council's investments with the bank are limited to amounts and matures within the terms of the stipulated guarantee and up to the limits above.
- **Building Societies with no credit ratings** –The Council will no longer invest with unrated societies.
- **UK Government** including gilts and the Debt Management Account Activity Deposit Facility (DMADF – a Government body which accepts local authority deposits)
- **HM Treasury Credit Guarantee Scheme** – the Council will invest in institutions that are included within this scheme initially announced on 13 October 2008. Any such investments will follow the same limits as set out above and will not exceed 12 months or £5m for any individual counterparty.
- **Council's own banker** – the Council will continue to invest with our own banker if they fall below the above criteria.

- **Pooled Investment Vehicles** – this includes AAA Money Market Funds or other AAA rated funds
- **Local Authorities, Parish Councils etc**

48. Country, group and sector exposure of the Council's investments will be monitored. The country selection will be chosen by the credit rating of the Sovereign state in the above.; no more than 10% will be placed with any non-UK country at any time; and sector limits will be monitored regularly for appropriateness.

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

50. The time limits for institutions on the Council's counterparty list are five years (these will cover both specified and non-specified Investments). Where a counter party is only on the Councils list because of a Government guarantee no loan will be entered into which exceeds the period of that guarantee. Investments for terms of one year or more are subject to prior approval by the Director of Finance & ICT. The proposed criteria for specified and non-specified investments are shown in paragraphs 67 to 73.

51. The use of longer term instruments (one year or greater from inception to repayment) will fall into the category of non-specified investments. These instruments will be used only where the Council's liquidity requirements are safeguarded. This usage is limited by Prudential Indicator for principal funds invested for one year or more at paragraph 56 below.

Economic Investment Consideration

52. Expectations on short-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.

53. The criteria for choosing counterparties set out above provide a sound approach to investment in "normal" market circumstances. Whilst Members are asked to approve this base criteria above, under the exceptional current market conditions the Director of Finance & ICT may temporarily (in conjunction with the Portfolio Holder for Finance and Economic Development) restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval.

Sensitivity to Interest Rate Movements

54. 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 treasury management income for next year. That element of the investment portfolio which is of a longer term, fixed interest rate nature will not be affected by interest rate changes.

Table 8: Sensitivity to Interest Rate Movements		
Revenue Budgets	**2010/11 Estimated + 1% £'000**	**2010/11 Estimated - 1% £'000**
Investment income	500	-500

Treasury Management Limits on Activity

55. There are four more treasury activity limits, which were previously prudential indicators. The purpose of these prudential indicators is 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 fixed interest rate exposure. This indicator identifies a maximum limit for fixed interest rates based upon the debt position net of investments
- Upper limits on variable interest rate exposure. Similar to the previous indicator, this covers a maximum limit on variable 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; upper and lower limits of each category are required.
- Total principal funds invested for one year or more. These limits are set to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

56. **Members are recommended to approve the indicators within Tables 9 and 10.**

Table 9: Exposure to fixed/variable interest rates (Prudential Indicators 9 and 10)			
	2009/10 Upper	**2010/11 Upper**	**2011/12 Upper**
Limits on fixed interest rates	100%	100%	100%
Limits on variable interest rates	30%	30%	30%

Table 10: Maturity structure of fixed interest rate borrowing and limits on longer term investments (Prudential Indicators 11 and 12)						
	2009/10		**2010/11**		**2011/12**	
Borrowing	**Lower**	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	0%	100%	0%	100%	0%	100%
12 months to 2 years	0%	0%	0%	0%	0%	0%
2 years to 5 years	0%	0%	0%	0%	0%	0%
5 years to 10 years	0%	0%	0%	0%	0%	0%
10 years and above	0%	0%	0%	0%	0%	0%
Maximum principal sums invested > 364 days	£30 m		£30 m		£30 m	

Performance Indicators

57. 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. As a debt free council with no externally managed funds, the only effective performance indicator that can be set is an achievement margin in excess of the 7 day LIBID rate, the London Interbank Bid rate, which is the generally accepted benchmark for local authority treasury operations. The results of these indicators will be reported in the Treasury Annual Report for 2009/10.

58. **Members are recommended to approve the local performance indicators set out in Table 11.**

Table 11: Performance indicator for the Council's Treasury operations			
	2009/10 %	**2010/11 %**	**2011/12 %**
Returns to exceed the 7 Day LIBID rate by:	0.10	0.10	0.10

59. The Council is aware that external fund managers are potentially able to achieve higher returns on an investment portfolio than in-house staff. However, these potential high returns are offset by the managers' fees. The Council has considered the net returns available through the use of external managers, and has decided to retain its policy of retaining the entire portfolio in-house. This policy will be kept under review each year.

Table 12: Returns achieved by the in-house Treasury team compared to the industry average net returns for external fund management teams			
	2006/07 %	**2007/08 %**	**2008/09 %**
In-house team	4.92%	5.85%	5.42%
External management (net of charges)	4.29%	5.86%	5.74%
Average 7 Day LIBID	4.82%	5.59%	3.69%

Treasury Management Advisers

60. The Council uses Butlers as its treasury management consultants. They provide technical support on treasury matters, capital finance issues, economic and interest rate analysis and credit ratings / market information service comprising the three main credit rating agencies. The current contract was let in 2007 and will expire on 30 April 2010.

61. 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.

Member and Officer Training

62. 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. We have addressed this by now having a qualified accountant as the treasury officer and both the Treasury Officer and the Principal Accountant attending appropriate courses.

63. Once the Council has determined the appropriate Member body to conduct the additional scrutiny on treasury management training will be arranged.

Treasury Management Practice (TMP) 1 (5) – Credit and Counterparty Risk Management

64. The Office of the Deputy Prime Minister (now the 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.

65. The key intention of the Guidance was to maintain the current requirement for Councils to invest prudently, giving priority to security before 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 18 April 2002 and will continue to apply its principles to all investment activity. In accordance with the Code, the Director of Finance & ICT has produced treasury management practices. This part, TMP 1(5), covering investment counterparty policy requires approval each year.

66. 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, to be approved by full Council and covering the identification and approval of:

- The strategy guidelines for decision making on 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.

Specified and Non-Specified Investments

67. Specified investments are sterling investments with original investment terms of not more than one year, or those which are agreed for a longer period 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. These include investments with:

    I The UK Government (such as the DMADF, UK Treasury Bills or a Gilt with less than one year to maturity).

    II A local authority, parish council or community council.

    III Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency.

    IV A financial body such as a bank or building society that has been awarded a high credit rating by a credit rating agency.

68. The Council proposes to invest in specified investments, with further restrictions related to credit ratings.

69. **Members are requested to confirm their approval of the following specified investments for this council:**

- **All Category I and II investments;**
- **For Category III – Pooled investment vehicles such as money market funds rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.**
- **For Category IV – banks and building societies which have the following Fitch or equivalent rating as a minimum:**
  i. Short Term – F1 (minimum of F1+ for total investment between £5m to £10m)
  ii. Long Term – A (minimum of AA- for total investments between £5m and £10m)
  iii. Individual / Financial Strength – C (Fitch / Moody's only)
  iv. Support – 3 (Fitch only)

70. Non-specified investments are any other type of investment (i.e. not defined as specified above). These would include sterling investments with:

I. Securities which are guaranteed by the UK Government (such as supranational bonds). These are fixed income bonds although the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.

II. Gilt edged securities with a maturity of greater than one year.

III. A government issued guarantee for wholesale deposits within specific timeframes and the government has an AAA sovereign long term rating from the three major credit agencies.

IV. An institution on the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008.

V. 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.

VI. A body that has been awarded a high credit rating by a credit rating agency (such as a bank or building society), for deposits with a maturity of greater than one year.

71. Proposals approved at Cabinet in December 2004 added the thirty largest building societies by capital asset base to the counterparty listing. A review of the counterparty criteria in August 2007 introduced limits on investments in unrated societies determined by their asset base. The Council will now only deal with building societies that satisfy the minimum rating requirements set out above.

72. Proposals approved at Cabinet in December 2004 also allow a limited proportion of funds to be invested for terms of between one and five years. On the advice of Butlers, any investment of a term of one year or more would be made only with a counterparty possessing a minimum long term credit rating of AA- (Fitch), Aa3 (Moody's) and AA- (Standard & Poors).

73. **Members are requested to confirm that, for the time being, it is intended that non-specified investments will not form part of the Council's investment portfolio, with the exception of;**

A maximum of £30,000,000 invested for terms of one year or more, subject to the credit rating criteria in Paragraph 72 and a maximum term of five years and institutions on the HM Treasury Credit Guarantee Scheme.

74. The credit rating of counterparties will be monitored regularly. The Council receives credit rating emails from its Treasury advisers as and when ratings change, and counterparties are checked promptly on receipt of these emails. Any counterparty failing to meet the criteria will be removed from the list immediately by the Director of Finance & ICT and if any new counterparties meet the criteria they will be added to the list.

75. The Council is aware that a counterparty may hold investments from the Council at the time that it is removed from the approved list due to a downgraded rating. The criteria used are high enough that a minor downgrading should not affect the full receipt of the principal and interest at maturity. Existing investments with the downgraded counterparty will therefore be allowed to run to maturity, unless there is reason to believe that an attempt should be made to retrieve the funds beforehand.

76. It should be noted that credit ratings are subject to change without prior warning, and that a high credit rating is an indication, not a guarantee, of a financial body's stability and creditworthiness.

Security, Liquidity and Yield Benchmarking

77. A proposed development for Member reporting is the consideration and approval of security and liquidity benchmarks. These are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons in the Annual Treasury or Mid-year Report.

78. **Yield** – This benchmark is currently widely used to assess investment performance.

- Investments – Interest returns 0.10% above the 7 day LIBID rate.

79. Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty criteria and some of the prudential indicators. However, they have not previously been separately and explicitly set out for Member consideration. Proposed benchmarks for cash type investments are set out 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.

80. **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 objectives. In respect of this area the Council seeks to maintain:

- Bank overdraft – the Council has a facility in place to use if necessary.
- Liquid short term deposit of at least £1.5M available with a maximum week's notice.

81. 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 0.50 years, with a maximum of 0.60 years.

82. **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 consideration, 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.

Table 13: Average historic default for investment grades

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%

83. The Council's minimum long term rating criteria is currently A, meaning the average expectation of default for a one year investment in a counterparty with a A long term rating would be 0.03% 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.

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

- 0.03% historic risk of default when compared to the whole portfolio.

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

The Treasury Management Policy Statement

The Council defines its treasury management activities as:

- The management of the organisation’s investments and cash flows, its banking, money market and capital market transactions;
- The effective control of the risks associated with those activities; and
- The pursuit of optimum performance consistent with those risks.

The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.

The Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

Credit Ratings

Long-Term Credit Ratings

Long-term credit ratings are set up along a scale from 'AAA' to 'D', and adopted and licensed by Standard and Poor (S&P). Moody's also uses a similar scale, but names the categories differently. Like S&P, Fitch also uses intermediate modifiers for each category between AA and CCC (i.e., AA+, AA, AA-, BBB+, BBB, BBB- etc.). Moodys intermediate modifers for each category between Aa to Caa are Aa1, Aa2, Aa3, A1, A2 etc.

Definitions (from S&P)	**Fitch**	**Moody**	**Standard & Poor**
Has extremely strong capacity to meet its financial commitments. Is the highest credit rating	AAA	Aaa	AAA
Has very strong capacity to meet its financial commitments. It differs from AAA only to a small degree	AA	Aa	AA
Has a strong capacity to meet its financial commitments, but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions	A	A	A
Has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity	BBB	Baa	BBB

Short-Term Credit Ratings

Short-term ratings indicate the potential level of default within a 12-month period.

Definitions (from S&P)	**Fitch**	**Moody**	**Standard & Poor**
Has extremely strong capacity to meet its financial commitments. Is the highest credit rating	F1+	P-1	A-1+
Has strong capacity to meet its financial commitments.	F1	P-2	A-1
Has satisfactory capacity to meet its financial commitments. However, more susceptible to the adverse effects of changes in circumstances and economic conditions	F2	P-3	A-2
Has adequate capacity to meet its financial obligations. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity	F3		A-3