APPENDIX A

2009/10 TREASURY MANAGEMENT STRATEGY
(Report by the Head of Financial Services)

1. INTRODUCTION

1.1 A Treasury Management Strategy ensures that the Authority has clear objectives for the management of its borrowing and investments. It is also needed to comply with the Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice, which is required by the Council's Code of Financial Management. The Government has also published Guidance which recommends that an Annual Investment Strategy is produced each year and approved by the full Council.

1.2 The Guidance emphasises that priority must be given to the security and liquidity of investments whilst the Code covers the same point by requiring the effective management and control of risk. This Strategy is intended to meet the requirements of the Code and the Guidance.

1.3 The Strategy takes account of the increased profile that treasury management has had in the last few months due to the collapse of Icelandic Banks in which many Local Authorities had investments.

1.4 When the Government removed its limits on capital expenditure levels some years ago it introduced the concept of a Prudential Code which pulled together a number of indicators relating to capital expenditure, external debt and treasury management. Its purpose was to demonstrate that the Council's capital expenditure plans were affordable and to provide a set of limits, to be complied with, and indicators to be monitored during the forthcoming year. These indicators are shown as Appendix B to the strategy.

1.5 The proposed strategy is attached as Annex A.

2. RECOMMENDATION

2.1 **Cabinet is requested to recommend to Council that it approves the attached Treasury Management Strategy.**

BACKGROUND PAPERS:

Background files in Accountancy Section: Treasury Management Reports
Reports on the 2009/10 Budget and Medium Term Plan to Cabinet and Council
CIPFA's Treasury Management in the Public Services Code of Practice 2002
ODPM Guidance on Local Government Investments March 2004

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Annex A

TREASURY MANAGEMENT STRATEGY 2009/10

Treasury Management is the process by which the Council:

- ensures it has sufficient cash to meet its day-to-day obligations
- borrows when necessary to fund capital expenditure, including borrowing in advance when rates are considered to be low
- invests any surplus funds in a manner that balances low risk of default by the borrower with a fair rate of interest.

This Strategy explains how this will be carried out and meets the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice and the Government's Guidance on Local Government Investments.

NEW FACTORS IN 2008/09

Over the period of its 5 year Medium Term Plan (MTP) the Council will need to start borrowing to fund capital expenditure once its existing Capital Reserves have been used. Agreement was reached with External Auditors that if the Council considered that long term borrowing rates were low it would be reasonable to borrow, in advance, up to the sum needed in the MTP. This was included in the 2008/09 Strategy.

During 2008/09, long term borrowing rates were volatile and when rates fell to around 3.90% in December the Council took out its first tranche of £10M long-term borrowing from the Public Works Loan Board (PWLB).

In October 2008 three Icelandic Banks collapsed that Councils, including this one, had on their approved list of counterparties. This raised the public profile of treasury management in Local Government and caused Councils to review their appetite for risk in managing their investments. It also highlighted the weaknesses of relying on credit ratings, the method used by most authorities to decide where to invest funds.

THE COUNCIL'S FINANCIAL STRATEGY

The extract below from the Council's Financial Strategy shows:

- how revenue reserves will fall to the basic level needed as a contingency against unexpected events,
- how capital reserves have already been nearly fully used to fund capital expenditure,
- how borrowing will be required to meet further planned capital expenditure. When this is carried out will depend on how low interest rates are perceived at any point in time. Hence "must" borrow levels reflect using other funds to delay until the last moment whilst "may" borrow levels show maximum borrowing in advance.

FORECAST	2008/09 £M	2009/10 £M	2010/11 £M	2011/12 £M	2012/13 £M	2013/14 £M
Revenue Reserves	19.1	15.3	10.4	6.0	3.0	3.0
Capital Reserves	1.3					
Earmarked Reserves	3.4	3.4	3.4	3.4	3.4	3.4
Total Reserves (EOY)**	**23.8**	**18.7**	**13.8**	**9.4**	**6.4**	**6.4**
Planned Capital Expenditure		17.8	6.1	5.0	6.7	6.4
Funded from:						
new capital receipts		1.1	0.9	0.7	0.7	0.7
capital reserves		1.3				
borrowing		15.4	5.2	4.3	6.0	5.7
Borrowing (accumulated)						
To be funded from borrowing		15.4	20.6	24.9	30.9	36.6
“Must” borrow	0	3.7	6.8	15.5	24.5	30.2
“May” borrow	26.3	36.5	41.0	45.7	50.6	55.5
Already borrowed	10.0	10.0	10.0	10.0	10.0	10.0

** excludes any cash flow surpluses and specific earmarked reserves (e.g. S106 and R&R Funds)

The amount and period of capital borrowing up until March 2010 will be dependent upon the actual levels of interest rates and how high or low they are perceived to be in a long term sense. For example, if long term rates fell to 3.5% we would be likely to move to our “may” borrow limits as soon as possible as, even if that meant an acceptable level of short term cost because temporary investment rates were lower than borrowing rates, the long term benefit would be significant. Conversely, if long term rates were 5% and it were perceived that future rates would be lower, only the “must” borrow limits would be followed and, even then, the sums would be borrowed for a short period rather than locked into a long term arrangement.

Authorities are only allowed to borrow short term for revenue purposes to cover cash flow.

CASH FLOW

In addition to the fundamental movements described above there are day-to-day impacts due to the flow of funds into and out of the Council. For instance, the dates on which the County Council is paid its portion of the council tax will be different to the days the money is received from those living in the District. These cash flows will sometimes leave the Council with several million pounds to borrow or invest overnight or for a few weeks.

LONG TERM BORROWING

Although borrowing is not required until 2009/10 to fund the Capital Programme, effective treasury management involves borrowing when interest rates are judged to be at the optimum level, even if the funds have then to be invested until the money is required; borrowing in this way is allowed if it is for planned capital expenditure. The definition of planned expenditure is not precise and has therefore been discussed with our external auditor who is comfortable with the interpretation of it being included in our approved MTP. Hence, once Council has approved the MTP in February the figure will be £36.5 M. The Council borrowed £10m in December 2008 for 49 to 50 years, when PWLB long-term interest rates were around 3.90% and the funds borrowed have been temporarily invested for 4 to 5 years at rates over 4%.

When the Council borrows the repayment profile of the debt must be considered if it is for a shorter period than the life of the asset being financed i.e. if the debt needed to be replaced rather than repaid then the replacement dates need to be spread over a sensible period to avoid peaks when interest rates may be high. Our borrowing from the PWLB is likely to be for sufficient period that the required depreciation charges will be enough to repay the debt rather than replace it.

Borrowing will tend to be from the Public Works Loans Board (PWLB) which is a Government Agency providing funds to government bodies at wholesale market rates. They provide a range of options including fixed rate loans for up to 50 years. Commercial bodies have become more involved in this market though their products are generally of the type where the lender retains an option to increase the interest rate after a number of years and the borrower has the right to repay if the new rate is not acceptable.

CATEGORIES OF INVESTMENT

The guidance on Local Authority Investments categorises investments as ‘specified’ and ‘non-specified’.

Specified investments are:

- in sterling
- due to be repaid within 12 months
- not defined as capital expenditure in the capital finance regulations 2003
- with a body that has a high credit rating or it is made with the UK Government (gilts or CDs), or a local Authority.

Non-specified investments include all other types of investment, for example corporate bonds.

The only non-specified investments that will be used will be time deposits of greater than 12 months with a body that has a high credit rating, is one of the larger building societies or has a legal position that guarantees repayment (e.g. a local authority). Time deposits are for specified periods and are returned in full after that period – they are not subject to value fluctuations as with Gilts and Corporate Bonds.

IN-HOUSE MANAGEMENT AND CDCM

CDCM currently manages £20M of investments and the remaining investments and borrowing are managed in-house. The bulk of CDCM’s fund will need to be returned in the next 2 years unless further advance borrowing is carried out. Now that there is not a longer-term nature to this fund it would be appropriate to regularly review the need for it and close it when appropriate.

Appendix A outlines the mandate for the in-house and CDCM investments and lists the approved counter-parties though it should be noted that these will change during the course of any year as credit ratings or the size of building societies change.

The Council will need to approve a prudential indicator for the ‘authorised limit for external debt’; which combines temporary borrowing for cash flow purposes and long-term borrowing to fund capital expenditure. A maximum of £56.5 is being recommended (£20m temporary plus £36.5 long term).

Although the MTP shows that the Authority will need to borrow to fund its capital programme it does not necessarily have to borrow from PWLB or the market because it can use its in-house investments to finance capital until the investments are used.

RISKS ASSOCIATED WITH INVESTMENTS

The collapse of the Icelandic Banks in October 2008 resulted in the Capital Receipts Advisory Group (CRAG) reviewing its appetite for risk as regards counterparties that the Council would be willing to invest with. Whilst investments could be made with the Government's Debt Management Office which are theoretically risk-free, as they are backed by the Government, there is a significant downside to this level of safety in that the rates offered have been up to 2% below the market rate – a major issue when base rate itself is only 2%.

Following detailed discussion, CRAG recommended that the, then current, counterparty list of banks and building societies should continue to be used. They felt that Building societies are such key financial institutions within the UK that if one got into financial difficulties it would either be taken over by another building society or supported by the Government. They also have a significant proportion of their funds covered by retail savings so are less at the risk of market volatility.

Whilst we have a reasonable number of institutions to invest with, the list reduces every time a bank or building society is taken over by another institution. It is possible that the level of advance borrowing could become limited by the availability of acceptable counterparties. This will be monitored closely.

Although many organisations rely on credit ratings to determine suitable counterparties and the Government advice refers to bodies with a "high" credit rating, recent events have shown that ratings are not totally reliable. Annex B shows the definition of the various credit ratings. The following changes have been made to mitigate this risk but they still only reduce it rather than remove it:

- The Council's Treasury Management advisors (Sterling) provide notice of institutions where the credit rating agencies have indicated a 'rating watch' which indicates that there may be a concern over the long-term stability of the bank or building society. These will often result in the counterparty being immediately removed from our list.
- Country limits have been set of £6M for non-EU countries, £10M for individual EU countries and £20M for EU in total. The EU limits exclude the UK.
- For shorter term investments the short-term credit rating is the most relevant, however as we may be investing in the medium-term when we have borrowed in advance it is prudent to take long-term credit ratings into account for any investment longer than I year. These should be A- or higher (FITCH) or the equivalent with other rating agencies

ADVISORS

The Council appointed Sterling Consultancy Services as Treasury Management Advisors in January 2008.

The Advisor carries out the following role:

- provides up-to-date information on credit ratings
- advises on borrowing, borrowing rates and opportunities to borrow early
- provides economic data and interest rate forecasts

KEY POINTS

Definition of 'high credit rating' for specified investments

The Council's mandates require all investments to have a short-term rating of a minimum of F1, as defined by the credit rating agency FITCH (or the equivalent for other rating agencies), except for any body that has a legal position that guarantees repayment or is a building society that is in the top 25 by value. Any investment for more than I year must also have a long term rating of at least A-

The frequency that credit ratings are monitored

Sterling monitors the credit ratings of banks and building societies daily and notifies the Council of any changes immediately. Where the rating is downgraded that bank or building society will immediately be removed from the counterparty list if its new rating is outside of the defined limits.

Sterling also notifies the Authority of counterparties where the credit rating is on negative rating watch. If the negative watch applies to long-term ratings a judgement will be made as to whether or not the counterparty should be removed from the list.

The categories of non-specified investments that can prudently be used during 2009/10

Time deposits over 12 months.

Liquidity of investments

The time deposits managed In-house and by CDCM are non-liquid investments (i.e. they will only be available at the end of the agreed period). CDCM's mandate specifies the dates by which sums need to be available for return. These sums will be regularly reviewed and CDCM advised of any necessary changes as the year progresses.

In addition to time deposits the Authority uses a liquidity funds with the NatWest Bank and Alliance Leicester, both of these allow repayment the same day.

Limiting Counterparty Risk

CDCM advise the Council of all proposed investments in advance. This allows the Council to ensure that the combined CDCM and In-house investment with a Counterparty does not exceed the specified limits. For example: Both lists would allow £6M with Barclays Bank but the Council will limit its investment with Barclays to £6M in total.

MANAGEMENT

The Head of Financial Services and his staff, supported by the Council's professional advisor, will manage and monitor investments and borrowing. The Capital Receipts Advisory Group will be kept informed of relevant issues and consulted on any significant changes to the Strategy.

The Cabinet will receive a six month report on the performance of the funds and an annual report on the performance for the year.

CHANGES TO THE STRATEGY

The strategy is not intended to be a strait-jacket but a definition of the upper limit of the level of risk that it is prudent for the Council to take in maximising the return on its net investments. Any changes that are broadly consistent with this Strategy and either reduce or only minimally increase the level of risk, are delegated to the Head of Financial Services, after consultation with the Capital Receipts Advisory Group, where significant.

Any other proposal to change this strategy will be referred back to the Council.

PRUDENTIAL INDICATORS

The Council's Prudential Indicators are attached at Appendix C. They are based on data included in the budget report and this Strategy. They set various limits that allow officers to monitor its achievement. These indicators must be approved by the Council and can only be amended by the Council.

Appendix A

Definition of Credit Ratings

Short term (FITCH)	**F1**	Shares rated in this category have the **most solid solvency levels** and the highest stock liquidity and enterprise value in the market.
	F2	Shares rated in this category have **very good solvency levels** and stock liquidity and enterprise value in the market.
	F3	Shares rated in this category have a **combination of good or adequate solvency levels** and stock liquidity and enterprise value in the market.
Long-term (FITCH)	**AAA**	Highest credit quality. 'AAA' ratings denote the **lowest expectation of credit risk.** They are assigned only in case of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.
	AA	Very high credit quality. 'AA' ratings denote **expectations of very low credit risk.** They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
	A	High credit quality. 'A' ratings denote **expectations of low credit risk.** The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.

Appendix B

IN-HOUSE FUND MANAGEMENT

Duration of investments	No investment shall be longer than 5 years.
Types of investments	Fixed Deposits Deposits at call, two or seven day notice
Credit Ratings	Short term rating F1 by FITCH IBCA or equivalent Long-term rating of A- by FITCH IBCA or equivalent if the investment is longer than 1year
Maximum limits per body or group	F1+ or have a legal position that guarantees repayment for the period of the investment — £6M F1 — £5M Building Society with assets over £2bn in top 25 (Currently 16) — £6M Building Society with assets over £1bn if in top 25 (Currently 3) — £5M Building Society with assets under £1bn in top 25 — £3M In **addition** to the above: Liquidity (Call) Account with a credit rating of F1+ or with a legal position that guarantees repayment. — £5M Other Country limits – £6M in a country outside the EU – £10M in a country within the EU (excluding UK) – £20M in EU countries combined (excluding UK) These totals apply to investments made up until 31 March 2010 but lower limits may be introduced for later years to avoid too high a proportion of the Council's funds being with any one counterparty.
Benchmark	LGC 7 day rate

CDCM MANDATE

Duration of investments	No investment shall be longer than 2 years. The following funds must be available for return by the dates listed below: £13M by 31 March 2010 £7M by 31 March 2011
Types of investments	Fixed Deposits Deposits at call, two or seven day notice
Credit Ratings	Short term rating F1 by FITCH IBCA or equivalent Long-term rating of A- by FITCH IBCA or equivalent if the investment is longer than I year
Maximum limits	F1+ or have a legal position that guarantees repayment for the period of the investment — £6M F1 — £5M Building Society with assets over £2bn in top 25 (Currently 16) — £6M Building Society with assets over £1bn if in top 25 (Currently 3) — £5M Building Society with assets under £1bn in top 25 — £3M Other Country limits – £6M in a country outside the EU – £10M in a country within the EU (excluding UK) – £20M in EU countries combined (excluding UK) These totals apply to investments made up until 31 March 2010 but lower limits may be introduced for later years to avoid too high a proportion of the Council's funds being with any one counterparty.
Benchmark	3 month LIBID

Appendix C

CIPFA Prudential Code for Capital Finance in Local Authorities Prudential Indicators for 2009/10

Capital expenditure

1. Actual and Estimated Capital Expenditure

	2007/8 Actual £000	2008/9 Forecast £000	2009/10 Estimate £000	2010/11 Estimate £000	2011/12 Estimate £000
Gross	**16,518**	**20,550**	**23,187**	**9,620**	**5,562**
Net	**13,833**	**15,347**	**17,796**	**6,056**	**4,957**

2. The proportion of the budget financed from government grants and council tax that is spent on interest.

The negative figures until 2009/10 reflect that the Authority is a net investor and so the interest earned is used to help fund the budget. In 2011/12 the borrowing costs exceed interest earned on investments

2007/8 Actual £000	2008/9 Forecast £000	2009/10 Estimate £000	2010/11 Estimate £000	2011/12 Estimate £000
-16%	**-11%**	**-4%**	**0%**	**1%**

3. The impact of schemes with capital expenditure on the level of council tax

This calculation highlights the hypothetical impact on the level of Council Tax from new capital schemes that the Council has approved in the budget/MTP. It must ignore changes already approved, slippage, inflation and savings.

The actual planned change in Council Tax is different because of the impact of other variations and the use of revenue reserves.

	2009/10 Estimate	2010/11 Estimate	2011/12 Estimate
Increase	**£8.34**	**-£2.21**	**£0.44**
Cumulative	**£8.34**	**£6.14**	**£6.58**

4. The capital financing requirement.

This represents the need for the Authority to borrow to finance capital expenditure. Whilst the Authority has capital reserves it will not have to borrow for capital purposes but may choose to do so:

31/3/08 Actual £000	2008/9 Forecast £000	2009/10 Estimate £000	2010/11 Estimate £000	2011/12 Estimate £000	2012/13 Estimate £000	2013/14 Estimate £000
0	**0**	**15,420**	**5,156**	**4,257**	**5,966**	**5,674**

It totals £36.5m over the MTP period.

5. Net borrowing and the capital financing requirement.

Borrowing must not be used to finance revenue spending except in the short term. In the short term it is legitimately used to cover cash flow e.g. funding salaries pending receipt of council tax income or return of investments.

The forecast shows that capital reserves are expected to run out in 2009/10 and the Authority will then need to fund most of its capital expenditure from long-term borrowing. However it is permitted to borrow a certain amount in advance of the need to fund capital expenditure (see paragraph 7 below).

External debt

6. The actual external borrowing at 31 March 2008

There was no borrowing.

7. The authorised limit for external debt.

This is the maximum limit for borrowing and is based on a worst-case scenario. It reflects the Treasury Management Strategy which allows the Authority to borrow up to £26.3m in 2008/09 and up to an aggregate of £36.5m in 2009/10 to finance capital expenditure shown to be financed from borrowing in the Medium Term Plan period if it appears that long term rates are attractive. The remainder of the limit relates to temporary debt for Cash Flow Purposes.

	2008/9 Limit £000	2009/10 Limit £000	2010/11 Estimate £000	2011/12 Estimate £000
Short term	20,000	20,000	20,000	20,000
Long Term	26,300	36,500	41,000	45,700
Total	**46,300**	**56,500**	**61,000**	**65,700**

8. The operational boundary for external debt.

This reflects a less extreme position. Although the figure can be exceeded without further approval it represents an early warning monitoring device to ensure that the authorised limit (above) is not exceeded; it allows the management of the Council's day to day cashflow. The short term and long term elements of the operational boundary will be monitored separately.

	2009/10 Limit £000	2010/11 Estimate £000	2011/12 Estimate £000
Short term	15,000	15,000	15,000
Long term	36,500	41,000	45,700
Total	**51,500**	**56,000**	**60,700**

Treasury management

9. Adoption of the CIPFA Code

The Prudential Code requires the Authority to have adopted the CIPFA Code of Practice for Treasury Management in the Public Services. This has been adopted.

10. Exposure to investments with fixed interest and variable interest as a percentage of total investments.

The mandates could result in a significant amount of the funds being at variable rates as CDCM has some deals where the rate is revised every quarter. In practice the exposure to variable rates is likely to be less and is effectively of a temporary nature due to the lender having an option to request repayment when rates fall.

	2009/10 Limit £000	2010/11 Estimate £000	2011/12 Estimate £000
Upper limit on fixed rate exposure	**100%**	**100%**	**100%**
Upper limit on variable rate exposure	**50%**	**50%**	**50%**

11. Borrowing Repayment Profile

The proportion of 2009/10 borrowing that will mature in successive periods.

The first table refers to temporary borrowing for cash flow purposes; 100% will mature in less than 12 months. Whilst long-term borrowing will often be for more than 10 years there are interest rate scenarios that might require shorter term borrowing on a temporary basis.

Cash flow borrowing	Upper limit	Lower limit
Under 12 months	**100%**	**100%**
12 months and within 24 months	**0%**	**0%**
24 months and within 5 years	**0%**	**0%**
5 years and within 10 years	**0%**	**0%**
10 years and above	**0%**	**0%**

Funding capital schemes	Upper limit	Lower limit
Under 12 months	**25%**	**0%**
12 months and within 24 months	**25%**	**0%**
24 months and within 5 years	**25%**	**0%**
5 years and within 10 years	**50%**	**0%**
10 years and above	**100%**	**0%**

12. Investment Repayment Profile

Limit on the value of investments that cannot be redeemed within 364 days i.e. by the end of each financial year.

	2009/10 Estimate £M	2010/11 Estimate £M	2011/12 Estimate £M
Limit on investments over 364 days as at 1 April each year.	**36,000**	**17,000**	**10,000**