APPENDIX A

Treasury Management Strategy Statement and Annual Investment Strategy 2011/12

1. INTRODUCTION/BACKGROUND

1.1. Treasury Management

1.1.1. Treasury Management relates to the policies, strategies and processes associated with managing the short and long term cash & debt of the Council through appropriate borrowing and lending activity.

1.2. Relevant Treasury Management Regulation / Legislation

The Council's treasury management activities are governed by the 2009 CIPFA Code of Practice for Treasury Management in the Public Sector, whose key requirement changes will be adopted by the Council in May 2011 as part of Financial Regulations (Section C.). This Code was revised in 2009, in light of the credit crunch and Icelandic Banks situation in 2008. Appendix A to this report outlines the key areas that were emphasised within the revised Code.

1.2.1. The Local Government Act 2003, effective from 1st April 2004;

- ~ Requires the Council to have regard to the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next 3 years to ensure that the Council's capital investment plans (including borrowing plans) are affordable, prudent and sustainable.
- ~ Requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy that sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.
- ~ Gives the Council statutory power to invest for "any purpose relevant to its functions under any enactment, or for the purposes of the prudent management of its financial affairs", including investments made in the course of treasury management.

1.3. Purpose of Report

1.3.1. This report comprises the Treasury Management Strategy Statement for 2011/2012 as Section 2 and the Annual Investment Strategy for 2011/2012 as Section 3 and has been prepared in accordance with the revised CIPFA Code of Practice for Treasury Management 2009.

1.3.1.1. <u>Treasury Management Strategy Statement 2011/2012</u>

The Treasury Management Strategy Statement is an annual statement that sets out the expected treasury activities for the forthcoming year 2011/2012.

1.3.1.2. <u>The Annual Investment Strategy 2011/2012</u>

The Annual Investment Strategy sets out the Council's policies for investing its surplus cash for the year 2011/2012 and for giving priority to the security and liquidity of its investments over the return on those investments. It forms the basis of the 'Approved Investment Criteria' followed by the Council when making its investments.

1.4. Reporting Arrangements

1.4.1. In accordance with the requirements of the revised Code, this Treasury Management Strategy and Annual Investment Strategy will be presented to the Value for Money Scrutiny Committee for scrutiny and then submitted to the Executive Councillor with responsibility for finance for approval prior to the start of the financial year.

1.4.2. Quarterly reports will then be presented to the Value for Money Scrutiny Committee throughout the financial year which will monitor and report on actual activity against the approved Strategy.

1.4.3. The aim of these reporting arrangements is to ensure that those with ultimate responsibility for the treasury management function appreciate fully the implications of treasury management policies and activities, and that those implementing policies and executing transactions have properly fulfilled their responsibilities with regard to delegation and reporting.

2. TREASURY MANAGEMENT STRATEGY STATEMENT 2011/2012

2.1. Introduction

2.1.1. The formulation of the annual Treasury Management Strategy involves determining the appropriate borrowing and investment decisions in light of the anticipated movement in interest rates. The strategy for 2011/2012 is therefore based upon the Treasury officers' current views on interest rates for the year ahead, supplemented with leading market forecasts provided by the Council's treasury management advisor, Sector Ltd. The strategy covers the following areas:

- The current external borrowing/investment position;
- Borrowing requirement 2010/2011 to 2014/2015;
- Affordable borrowing limit in force that will limit the treasury risk and activities of the Council;
- Prudential indicators 2011/2012 to 2013/2014
- Prospect for interest rates 2011/2012;
- Long term capital borrowing strategy 2011/2012;
- Debt rescheduling opportunities;
- Investment strategy 2011/2012;
- Short term (cash flow) borrowing strategy 2011/2012
- Other current treasury issues.

2.2. Current Long Term Capital Borrowing & Investment Position

2.2.1. In order to place the Treasury Management Strategy in context, the Council's treasury portfolio position at 31.1.2011 comprised:

		Principal £million	Ave Rate %
Long Term Borrowing			
Opening Balance	31.3.10	390.752	4.21
New Borrowing to	31.1.11	70.000	3.85
Borrowing Repaid to	31.1.11	(11.883)	
Rescheduling:			
Borrowing Repaid Early to	31.1.11	0	
Borrowing Replaced	31.1.11	0	
Total Borrowing at	**31.1.11**	**448.869**	**4.15**
Investments			
LCC at	31.1.11	265.361	
Pension Fund at	31.1.11	14.829	
Total Investments at	**31.1.11**	**280.190**	**0.87**
Net Borrowing at	**31.1.11**	**183.508**	

2.3. Long Term Borrowing Requirement 2010/2011 to 2014/2015

2.3.1. The long term borrowing requirement for the remainder of 2010/2011 to 2014/2015, as detailed in the County Council Budget 2011 report, which is to be considered by the County Council at its meeting on the 11th February 2011, is as follows:

Long Term Borrowing Requirement	**Further in 2010/11 £m**	**2011/12 £m**	**2012/13 £m**	**2013/14 £m**	**2014/15 £m**	**Total £m**
New Borrowing	31.463	85.739	82.447	44.796	42.500	286.945
Replacement Borrowing	8.000	5.000	5.000	2.000	5.000	25.000

2.3.2. This borrowing requirement falls within the Council's 'affordable borrowing limit' as outlined below.

2.4. Affordable Borrowing Limit for 2011/2012 to 2013/2014

2.4.1. The Council has a statutory duty, in accordance with the Local Government Act 2003, to determine and keep under review how much it can afford to borrow i.e. to determine its "Affordable Borrowing Limit".

2.4.2. The Council must have regard to the Prudential Code when setting its Affordable Borrowing Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax levels is acceptable. Both external borrowing and other forms of financing, such as finance leasing and private finance initiative arrangements (PFI) are to be included within this Affordable Borrowing Limit.

2.4.3. It is also a statutory requirement under Section 33 of the Local Government Finance Act 1992 for the Council to produce a balanced budget. This means that increases in capital expenditure must be limited to a level whereby increased capital finance costs are set to a level that is affordable within the projected income of the Council for the foreseeable future.

2.4.4. The Prudential Indicator for the 'Authorised Limit for External Debt', as required by the Prudential Code, is the statutory Affordable Borrowing Limit as determined under the 2003 Act, and this limit must be set on a rolling basis for the forthcoming financial year and two successive financial years. The Council's Authorised Limit For External Debt for 2011/12 to 2013/14 has been set as follows: -

	2011/12 £million	2012/13 £million	2013/14 £million
Borrowing	595.954	641.938	658.688
Other Long Term Liabilities	18.500	18.000	17.250
TOTAL	**614.454**	**659.938**	**675.938**

2.4.5. The Assistant Director – Finance & Resources has responsibility to set the Authorised Limit for External Debt, to monitor the external debt level and to report to the Executive Councillor with responsibilities for finance, if he is of the view that the limit is likely to be breached. The Executive Councillor has then to decide to take appropriate action for the limit not to be breached or to raise the limit if prudent to do so.

2.5. Prudential Indicators for 2011/2012 to 2013/2014

2.5.1. Appendix B outlines the Council's Prudential Indicators that are relevant for the purposes of setting an integrated treasury management strategy.

2.5.2. They have been extracted from the comprehensive list of all Prudential Indicators proposed for the Council submitted, as per the requirements of the Prudential Code, with the County Council Budget 2011 report, which are to be considered at the meeting of the County Council on 11th February 2011.

2.6. Prospect for Interest Rates 2011/2012

2.6.1. The Council has appointed Sector Treasury Services as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates taking into account the current outlook for the UK Economy. Appendix C draws together a number of current City Institution forecasts for short term and longer fixed interest rates. The following table gives the Sector central view.

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Mar-13	Mar-14
Bank rate	0.50%	0.50%	0.50%	0.75%	1.00%	2.25%	3.25%
5yr PWLB rate	3.30%	3.30%	3.40%	3.50%	3.60%	4.30%	5.00%
10yr PWLB rate	4.40%	4.40%	4.40%	4.50%	4.70%	5.10%	5.40%
25yr PWLB rate	5.20%	5.20%	5.20%	5.30%	5.30%	5.50%	5.70%
50yr PWLB rate	5.20%	5.20%	5.20%	5.30%	5.30%	5.50%	5.70%

Economic Background

2.6.2. There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected. A detailed view of the current economic background is contained within Appendix D to this report.

2.7. Long Term Borrowing Strategy 2011/2012

2.7.1. In view of the above forecast for interest rates the Council's borrowing strategy will be based upon the following information.

2.7.1.1. Rates are expected to gradually increase during the year so it should therefore be advantageous to time new long term borrowing in the first half of the financial year when PWLB rates are at the following target levels: 50 yr & 25 yr – 5.20%, 10yr – 4.40% and 5 yr – 3.30%.

2.7.1.2. PWLB rates on loans of less than 15 years duration are expected to be substantially lower than longer term PWLB rates offering a range of options for new borrowing which will spread debt maturities away from a concentration in long dated debt.

2.7.1.3. Fixed rate market loans and LOBO[1] loans may be available at rates significantly below PWLB rates. However an appropriate balance between PWLB and market debt should be maintained in the debt portfolio.

2.7.1.4. Over the next three years investment rates are expected to be below long term borrowing rates. Consideration has to be made regarding the option of making short term savings by using existing investment balances to finance new capital expenditure (known as internal borrowing) instead of taking external borrowing, against the potential for incurring additional long term extra costs by delaying unavoidable new external borrowing until later years when PWLB long term rates are forecast to be significantly higher.

2.7.1.5. Temporary borrowing (up to 1 year) from the money market or other local authorities, at investment level rates, will be an available option.

[1] A LOBO is a 'Lender's Option, Borrowers Option' money market loan, whereby the Lender has the option to change the rate of a loan after a designated fixed period of time and the Borrower (LCC) has the option to accept this new rate or repay the loan. The fixed period of time is typically for 1 to 20 years and the total length of the LOBO is typically for 50 to 70 years.

External V Internal Borrowing

2.7.2. The table below shows the comparison between the Council’s gross and net debt positions at the year end from 2009/10 to 2013/14.

Comparison of gross and net debt at year end	**2009/10 Actual £m**	**2010/11 Probable Outturn £m**	**20011/12 Estimate £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**
Actual External Debt (Gross)	390.752	464.051	530.952	585.389	602.500
Cash Balances (Investments)	209.630	176.524	162.824	162.824	162.824
Net Debt	181.122	287.527	368.128	422.565	439.676

2.7.3. The table shows that the difference between gross and net debt is the level of investments held by the Council. In theory these investments could be used to pay off the Council’s external debt to the net position, thereby reducing the credit risk of holding investments and the interest rate risk by making savings in the short term in times when investment rates are lower than borrowing rates.

2.7.4. The level of the Council Investments compared to its borrowings is not thought to be significant and credit risk (default risk) is mitigated by the Councils Credit Worthiness Policy as detailed in the Annual Investment Strategy highlighted in Section 3.

2.7.5. Higher PWLB long term rates are forecast in the next few years which will be a considering factor over any decision to delay new long term borrowing in 2011/12 or repay existing debt by using internal borrowing (investment balances).

Minimum Revenue Provision / Repayment of Debt

2.7.6. New regulations in 2008 set a duty for the Council to set aside a minimum revenue provision (MRP) for the repayment of debt to the Revenue Account each year which it considers to be prudent. Statutory guidance which accompanies the regulations provides options for calculating MRP. The aim is to ensure that debt is repaid over a period reasonably commensurate with the period over which the capital expenditure funded by borrowing provides benefits.

2.7.7. The Council at its meeting on 13th February 2009 agreed to apply the average life method of calculating MRP for 2009/10 onwards, as supported by the then Resources Policy Development Group and the Council’s External Auditors. Full details of the proposal from the Resources PDG 12 January 2009 can be found as Appendix E.

2.7.8. The Council’s policy is to repay external debt at the MRP level and as a measure of affordability the following voluntary Prudential Indicator Limit has been set:

‘**MRP and Interest as a percentage of the Councils Income will not exceed 10%’.**

Borrowing in Advance of Need

2.7.9. The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Council can ensure the security of such funds. In determining whether borrowing will be undertaken in advance of need the Council will:

- ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to take funding in advance of need.
- ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered.
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow.
- consider the merits and demerits of alternative forms of funding.
- consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use.

2.7.10. Given the factors detailed in 2.7 above, the following borrowing strategy will be adopted for 2011/12:

The Council will take new borrowing from the PWLB in periods of up to 15 years to benefit from the lower rates for these maturities. Borrowing for longer than this period will also be considered with the aim of achieving an even spread of maturity profile, if rates come back to targets levels identified in 2.7.1.1. A significant proportion of the borrowing requirement will be taken in the first half of the year before rates are forecast to rise.

Consideration will be given to borrowing market loans or LOBOs, to fit into the above maturity strategy, in order to take advantage of the lower rates offered on these loans. This proportion limited to no more than 10% of total external borrowing for each of market loans and LOBO's.

Temporary borrowing from the money markets or other local authorities will be considered if appropriate.

Borrowing in advance of need will be undertaken during the year if considered appropriate following the Council's policy as detailed in 2.7.9 above.

2.7.11. To support the above strategy, prevailing interest rates and market forecasts will be continually monitored throughout the year and appropriate borrowing actions including debt rescheduling, if appropriate, will be taken in response to any sharp rise or fall in long and short term interest rates occurring throughout the year.

2.8. Debt Rescheduling

2.8.1. Debt rescheduling involves repaying existing loans and replacing these with new loans at different terms for the prime objective of generating financial savings on interest paid.

2.8.2. The Council's Financial Strategy states that 'the Council will actively pursue debt rescheduling to the extent that it will generate financial savings without adding significantly to the overall debt burden'.

2.8.3. To date interest savings have been made by rescheduling existing PWLB EIP[2] loans into PWLB maturity[3] loans. At the time of writing £25.70 million of EIP debt, from the Council's total debt portfolio of £438.87 million, remains to be rescheduled given the opportunity.

2.8.4. Interest savings may also be achievable in 2011/12 by switching from long term PWLB debt to short term Market Debt or LOBOs, but only in consideration of maintaining an even maturity profile of debt.

[2] With EIP loans, an equal amount of principal is repaid on a half yearly basis throughout the term of the loan with interest calculated on the reducing balance, hence total payments reduce over the lifetime of the loan.

[3] With Maturity loans, only interest repayments are made during the life of the loan and repayment of principal is made in full at the end of the loan period.

2.8.5. Repaying debt early does incur a premium[4] or discount[5] depending on the current level of interest rates compared to the rate of interest on the debt repaid. The timing of any rescheduling during the year will take place to minimise premium or maximise the discount available. This is achieved by repaying loans at a peak in current interest rate levels to reduce the amount of premium due and locking into replacement loans at a trough in current interest rates. This strategy can incur an interest cost due to the delay in replacing debt repaid or interest can be made by borrowing in advance of repaying debt. There is also a level of interest rate risk of any timing decision.

2.8.6. Where possible suitable loans will be selected for rescheduling that match out both premium and discounts, thereby eliminating the cash impact to the Council. Any positions taken via rescheduling will be in accordance with the borrowing strategy position outlined in Section 2.7 above.

2.8.7. The appropriate timing of any rescheduling will be monitored throughout 2011/12 by the Council and Sector Ltd. However due to the introduction by the PWLB in 2007 of a spread between the rates applied to new borrowing and repayment of debt, which has now been compounded, since the rate increases on 20 October 2010, by a considerable further widening of the difference between new borrowing and repayment rates, means that PWLB to PWLB debt restructuring is now much less attractive because of the large premiums that would be incurred.

2.9. Investment Strategy 2011/2012

2.9.1. Bank Rate has been unchanged at 0.50% since March 2009. It is forecast to commence rising from November 2011 ending 2011/12 at 1.00%. There is downside risk to this forecast if recovery from the recession proves to be weaker and slower than currently expected.

2.9.2. The Council has average investments of around £250 million net of Pension Fund cash, of which £150 million can be identified as ‘core’ balances which will be available to invest for longer periods of investment. The remaining balance of cash is cash flow driven.

2.9.3. The Council’s investment priorities are:

(a) the security of capital and
(b) the liquidity of its investments

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[4] A premium is incurred on repaying a loan early when the interest rate of the loan to be repaid is higher than the current rate available for the remaining duration of the existing loan.

[5] A discount is incurred on repaying a loan early when the interest rate of the loan to be repaid is lower than the current rate available for the remaining duration of the existing loan.

The Council will aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity and hence has a low risk appetite for placing investments.

2.9.4. Given these factors above, the following investment strategy will be adopted for 2011/12:

The Council will avoid locking into longer term deals (beyond 1 year) while investment rates are down at historically low levels unless exceptionally attractive rates are available which make longer term deals worthwhile. Investments will be made in all periods of 3 months to 1 year, to acceptable counterparties, to lock into rates in excess of the predicted base rate level where possible throughout the year for some element of the Council's investment portfolio that represents 'core' balances. Extensive use of Bank Business Reserve Accounts and Money Market Funds[6] will be made, that offer returns in excess of base rate level, for the Council's 'core' cash and cash flow generated balances. The target investment return for investments in 2011/12 is 1.10%.

Short term investment in Certificates of Deposit[7] and Treasury Bills[8] will also be considered where appropriate.

Short dated deposits (overnight to 1 month) will also be made for the Council's cash flow generated balances in order to benefit from compounding of interest.

2.9.5. In addition to the above strategy, prevailing interest rates and market forecasts will be continually monitored throughout the year and appropriate investment actions will be taken in response to any sharp rise or fall in long and short-term interest rates occurring throughout the year.

2.9.6. All Investments will be made in accordance with the Council's Annual Investment Strategy, as outlined in Section 3 of this report and with the institutions identified in the Councils approved counterparty investment list.

2.9.7. At the time of writing, the Council has no outstanding investments over 1 year in duration.

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[6] Pooled investment vehicles offering returns equivalent of up to 1 month cash deposits whose assets comprise of cash type investments such as Certificates of Deposit, Commercial Paper and Cash Deposits.

[7] A bearer instrument which certifies that a sum of money has been deposited with the bank issuing the certificate at a fixed yield and on the stated maturity date the deposit is repaid with interest. The maturity length is typically from 1 month to 1 year.

[8] Short term securities issued by HM Treasury on a discounted basis i.e. issued below 100, with 100 being received on maturity with the difference equalling the interest return.

2.10. Short Term (Cash Flow) Borrowing Strategy 2011/2012

2.10.1. During 2011/2012 when short term interest rates for temporary borrowing are significantly lower than yields earned on the Council's Call Accounts and Money Market Funds, then if required for cash flow purposes, temporary short term borrowing will be taken instead of drawing on investments, in order to minimise the loss of interest from withdrawing funds at higher rates.

2.11. Other Current Treasury Issues

2.11.1. Long Term Borrowing – School Loans Scheme 2011/12

Long Term Borrowing from the PWLB on behalf of schools as part of the schools loan scheme will be undertaken throughout 2011/2012 as and when required and on terms requested by schools.

2.11.2. Leasing Requirements – School IT and General Equipment

It is anticipated that up to £500,000 of School IT and general equipment may be leased in 2011/2012 as part of an agreed strategy for acquiring use of such equipment by schools. Three and five year finance leases will be arranged on behalf of the schools as required.

2.11.3. Policy on the Use of External Service Providers

The Council uses Sector Treasury Services as its external treasury management advisers.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

2.11.4. Pension Fund Cash

In line with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 which were implemented on 1st January 2010, effective from 1st April 2010, an agreement has been drawn up governing the procedures that were already in place for the pooling of Pension Fund cash with Council balances for investment. This agreement has been attached as Appendix F.

3. ANNUAL INVESTMENT STRATEGY 2011/2012

3.1. In accordance with Section 15(1) of the Local Government Act 2003, Lincolnshire County Council has adhered to the guidance on investments issued by the Secretary of State, and as such has produced its Annual Investment Strategy for 2011/2012 as follows:

3.2. Specified Investments

3.2.1. In accordance with CLG guidance, this Council will invest its surplus funds throughout the year in the following specified investments, which it regards as offering high security and high liquidity.

- Investments made in sterling, which mature within & including 12 months (such investments to include fixed, callable or forward term deposits as appropriate[9], Certificates of Deposit and Treasury Bills), with the following categories: -

  - UK Government
  - Local Authorities
  - Body or Investment Scheme meeting the required level of credit quality as determined by credit rating agencies.*

*Lincolnshire County Council has determined this required level of credit quality to be as follows: -

Body or Investment Scheme	**Sector Weighted Credit Colour Band**	**Minimum Acceptable Credit Rating ****
Bank or Building Society	Blue (Nationalised / Semi Nationalised UK Banks only	Long Term Rating (Fitch): AA-
	Orange	
	Red	Sovereign Rating (Fitch): AAA
	Green	
Money Market Funds		Long Term Rating (Moodys): Aaa/MR1+ or (Fitch): AAA or (S & P): AAAm

**For definition of credit ratings see Appendix G.

[9] Fixed Deposit : Investment fixed for specific term at specific rate.
Callable Deposit : Investment whereby borrower has option to pay back deposit at specific intervals.
Forward Deposit : Investment whereby period, rate and amount are agreed in advance of a future date. The forward period plus the deal period to be within the maturity limit allowed.

This Council uses the creditworthiness service provided by Sector its treasury management advisor. This service has been progressively enhanced and now uses a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moodys and Standard and Poors, forming the core element. However, it does not rely solely on the current credit ratings of counterparties but also uses the following as overlays:

- Credit watches and credit outlooks from credit rating agencies –see Appendix G for definition.
- Credit default swap (CDS) spreads to give early warning of likely changes in credit ratings – see Appendix G for definition.

This modelling approach combines credit ratings, credit watches, credit outlooks and CDS spreads in a weighted scoring system for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. The Council is satisfied that this service gives an improved level of security for its investments. It is also a service which the Council would not be able to replicate using in house resources.

In addition to the Sector service, the Council has also retained an additional minimum Long Term rating from Fitch of –AA and a minimum Sovereign (Country) rating from Fitch of AAA. (For definitions of these ratings please refer to Appendix G). This restricts the number of acceptable counterparties further, however it is not felt that these restrictions should be relaxed at this time. A further limit of a maximum of no more than 20% of total investments to be placed with any one bank/group or building society sector is also in place to ensure diversification of investments.

From the above methodology the following duration and amount limits have been assigned to each colour band as follows:

Sector Weighted Colour Band	**Maximum Duration**	**Maximum Amount**
Blue***	1 Year	£20m
Orange	1 Year	£20m
Red	6 Months	£15m
Green	3 Months	£10m

*** *<u>Applies to nationalised or semi nationalised UK Banks</u>*:-
As a result of the banking crisis which started in 2008, Governments across the world have had to inject capital directly into banks to support their capital ratios and to avoid failure of financial institutions. Several banks have been nationalised or part nationalised in this way.

These nationalised banks in the UK have credit ratings which do not conform to the credit criteria usually used by Councils to identify banks which are of high credit worthiness. As they are no longer separate institutions in their own right, their individual ratings, which assess their stand alone financial strength, are impaired. However it is considered that institutions that have been nationalised or part nationalised effectively take on the creditworthiness of the Government itself and as such UK nationalised or semi nationalised banks are included within the Councils acceptable investment criteria.

3.2.2. The Assistant Director –Finance & Resources has delegated responsibility to produce an 'Approved Lending List' of acceptable counterparties to whom the Council will lend its surplus cash which comply with the specified investments detailed above and the non-specified investments detailed below. The credit ratings of counterparties are monitored on an ongoing basis. The Council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service.

- If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

- In addition to the use of Credit Ratings the Council will be advised of information in movements in CDS prices of Counterparties against the iTraxx benchmark[10] and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or suspension from the Councils lending list.

3.2.3. Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on government support for banks and the credit ratings of that government support.

3.3. <u>Non-Specified Investments</u>

3.3.1. In accordance with CLG guidance on investments, non-specified investments are those that do not meet the definition of specified investments as detailed above, and they are viewed as being higher risk.

[10] iTraxx Senior Financials Index that measures the "average" level of the most liquid financial CDS prices in the CDS market.

3.3.2. Having assessed the acceptable level of risk involved in all non-specified investments, it is the decision of the Assistant Director- Finance & Resources to allow the prudent investment in the following non-specified investments:

- Sterling investments for a maturity period greater than 12 months up to a maximum of 2 years, (such investments to include fixed, callable or forward deposits as appropriate).

3.3.3. The above non-specified investments may be made to any category as detailed in the specified investments above, with the exception of Bodies or Investment Schemes that will be restricted to the following level of credit worthiness criteria:

Body or Investment Scheme	**Sector Weighted Credit Colour Band**	**Minimum Acceptable Credit Rating ****
Bank or Building Society	Purple	Long Term Rating (Fitch): AA-
		Sovereign Rating (Fitch): AAA

** For definition of credit ratings see Appendix G

The following duration and amount limits have been assigned to this colour band as follows:

Sector Weighted Colour Band	**Maximum Duration**	**Maximum Amount**
Purple	2 Years	£25m

3.3.4. In line with the Prudential Code Indicator, the maximum amount of investment that can be held in investments over 12 months at any one time is £40 million. This limit reflects a prudent proportion of the Council's estimated level of core cash balances available to invest for longer periods.

3.3.5. The Executive Councillor with responsibility for finance will be informed on any occasion when investments are lent for over 12 months.

3.4. Additions to Non-Specified Investment List

3.4.1. Proposals to invest in any other non-specified investment will be referred to the Assistant Director of Resources for approval after first seeking the advice of the Authority's Treasury advisors, Sector Ltd. If approved by the Assistant Director – Finance & Resources, a recommendation for the change to the Annual Investment Strategy will be sought from the Executive Councillor with responsibility for finance.

3.5. Liquidity of Investments

3.5.1. In determining the amount of funds that can prudently be committed for more than 12 months, consideration will be given to the following factors:

- Long Term Cash Flow Forecasts of the Council -3 years ahead showing:
  - Projected core cash balances over the term of proposed investment
  - Foreseeable spending needs over the term of proposed investment.
  - Level of provision for contingencies.
  - Acceptable level of reserves.

3.6. Scheme of Delegation / Role of S151 Officer

3.6.1. Executive Councillor With Responsibility for Finance

- Approves the Annual Investment Strategy along with Treasury Management Strategy on annual basis prior to start of financial year.
- Approves any changes to the Specified/Non Specified investments throughout the year on recommendation by the Assistant Director – Finance & Resources.
- Receives notification of any funds invested for over 12 months from Treasury Manager.

3.6.2. Value For Money Scrutiny Committee

- Scrutinise Annual Investment Strategy along with Treasury Management Strategy on annual basis prior to start of financial year.
- Scrutinise any changes to the Annual Investment Strategy on quarterly basis throughout the year.

3.6.3. <u>Section 151 Officer</u>

- Responsible for producing and submitting the Annual Investment Strategy and any subsequent changes to the Executive Councillor with responsibility for finance.
- Delegated authority to produce and approve variations to Councils Authorised Lending List in conjunction with the Head of Finance.

ANNEX A

The Revised CIPFA Treasury Management Code of Practice 2009 – Key Areas

The revised Code has emphasized a number of key areas including the following: -

a) All councils must formally adopt the revised Code and four clauses
b) The strategy report will affirm that the effective management and control of risk are prime objectives of the Council's treasury management activities.
c) The Council's appetite for risk must be clearly identified within the strategy report and will affirm that priority is given to security of capital and liquidity when investing funds and explain how that will be carried out.
d) Responsibility for risk management and control lies within the organisation and cannot be delegated to any outside organisation.
e) Credit ratings should only be used as a starting point when considering risk. Use should also be made of market data and information, the quality financial press, information on government support for banks and the credit ratings of that government support.
f) Councils need a sound diversification policy with high credit quality counterparties and should consider setting country, sector and group limits.
g) Borrowing in advance of need is only to be permissible when there is a clear business case for doing so and only for the current capital program or to finance future debt maturities.
h) The main annual treasury management reports should be approved by full council.
i) There needs to be, at a minimum, a mid year review of treasury management strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved.
j) Each council must delegate the role of scrutiny of treasury management strategy and policies to a specific named body.
k) Treasury management performance and policy setting should be subjected to prior scrutiny.
l) Members should be provided with access to relevant training.
m) Those charged with governance are also personally responsible for ensuring they have the necessary skills and training.
n) Responsibility for these activities must be clearly defined within the organisation.
o) Officers involved in treasury management must be explicitly required to follow treasury management policies and procedures when making investment and borrowing decisions on behalf of the Council (this will form part of the updated Treasury Management Practices).

ANNEX B

PRUDENTIAL INDICATORS:	2010/11	2011/12	2012/13	2013/14
Affordability:				
Increase in council tax levels	£6.41	£31.79	£28.73	£20.38
Ratio of Net Financing Costs to Net Revenue Stream	4.32%	5.28%	5.91%	6.14%
Ratio of MRP & Interest Payments to Net Revenue Stream -10% limit (Voluntary Indicator)	4.36%	5.34%	6.18%	6.72%
	£m	**£m**	**£m**	**£m**
Capital Expenditure:				
Capital Financing Requirement (as at 31 March)	487.734	552.804	605.561	620.870
TREASURY INDICATORS (within the Prudential Code):				
Authorised limit for external debt -				
Borrowing	547.452	595.954	641.938	658.688
Other long term liabilities	19.200	18.500	18.000	17.250
TOTAL	566.652	614.454	659.938	675.938
Operational boundary -				
Borrowing	532.452	571.954	617.938	634.688
Other long term liabilities	17.200	16.500	16.000	15.250
TAL	549.652	588.454	633.938	649.938
TREASURY INDICATORS (with the TM Code):				
Upper limit for fixed interest rate exposure	**£m**	**£m**	**£m**	**£m**
Net principal re fixed rate borrowing less investments	620.870	620.870	620.870	620.870
Upper limit for variable rate exposure	**£m**	**£m**	**£m**	**£m**
Net principal re variable rate borrowing less investments	186.261	186.261	186.261	186.261
	£m	**£m**	**£m**	**£m**
Upper limit for total principal sums invested for over 364 days	40.000	40.000	40.000	40.000
(per maturity date)				

Maturity structure of new fixed rate borrowing during 2011/12	upper limit	lower limit
under 12 months	25%	0%
12 months and within 24 months	25%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	75%	0%
10 years and above	100%	0%

ANNEX C

INTEREST RATE FORECASTS FOR 2011/2012

The data below shows a variety of forecasts published by a number of institutions. The first three are individual forecasts including those of UBS and Capital Economics (an independent forecasting consultancy). The final one represents summarised figures drawn from the population of all major City banks and academic institutions. The forecast within this strategy statement has been drawn from these diverse sources and officers' own views.

1.INDIVIDUAL FORECASTS

Sector interest rate forecast – 6.1.11

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
Bank rate	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.25%	2.75%	3.00%	3.25%	3.25%
3 month LIBID	0.60%	0.70%	0.80%	1.00%	1.25%	1.50%	1.75%	2.00%	2.50%	3.00%	3.25%	3.50%	3.50%
6 month LIBID	0.90%	1.00%	1.10%	1.20%	1.50%	1.80%	2.10%	2.40%	2.80%	3.20%	3.50%	3.80%	4.00%
12 month LIBID	1.40%	1.50%	1.60%	1.80%	2.10%	2.40%	2.70%	3.00%	3.20%	3.40%	3.65%	4.00%	4.20%
5yr PWLB rate	3.30%	3.30%	3.40%	3.50%	3.60%	3.80%	3.90%	4.10%	4.30%	4.60%	4.80%	4.90%	5.00%
10yr PWLB rate	4.40%	4.40%	4.40%	4.50%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%	5.40%	5.40%
25yr PWLB rate	5.20%	5.20%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.60%	5.70%	5.70%
50yr PWLB rate	5.20%	5.20%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.60%	5.70%	5.70%

Capital Economics interest rate forecast – 12.1.11

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.50%	2.00%
5yr PWLB rate	3.20%	3.20%	3.00%	2.75%	2.75%	2.90%	3.00%	3.20%	3.40%	3.60%	3.90%	4.20%
10yr PWLB rate	4.75%	4.75%	4.25%	3.75%	3.75%	3.75%	3.75%	3.75%	3.90%	4.00%	4.30%	4.60%
25yr PWLB rate	5.25%	5.25%	4.85%	4.65%	4.65%	4.65%	4.65%	4.65%	4.75%	4.85%	5.10%	5.30%
50yr PWLB rate	5.30%	5.30%	5.20%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.10%	5.20%	5.30%

UBS interest rate forecast (for quarter ends) – 6.1.11

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
Bank rate	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%
10yr PWLB rate	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%
25yr PWLB rate	5.25%	5.30%	5.35%	5.40%	5.45%	5.50%	5.55%	5.60%
50yr PWLB rate	5.35%	5.40%	5.45%	5.50%	5.55%	5.60%	5.65%	5.70%

2. SURVEY OF ECONOMIC FORECASTS

HM Treasury December 2010 – The current Q4 2010 and 2011 forecasts are based on the December 2010 report. Forecasts for 2010 – 2014 are based on 32 forecasts in the last quarterly forecast – in November 2010.

BANK RATE FORECASTS		quarter ended		annual average Bank Rate			
	actual	Q4 2011		ave. 2011	ave. 2012	ave. 2013	ave. 2014
Median	0.50%	2.00%		0.90%	1.60%	2.40%	3.00%
Highest	0.50%	0.50%		2.10%	3.10%	3.60%	4.50%
Lowest	0.50%	0.80%		0.50%	0.50%	0.60%	1.20%

ANNEX D

Economic Background – Source Sector Treasury Services Ltd

1. Global economy

The sovereign debt crisis peaked in May 2010 prompted, in the first place, by major concerns over the size of the Greek government's total debt and annual deficit. However, any default or write down of Greek debt would have substantial impact on other countries, in particular, Portugal, Spain and Ireland. This crisis culminated in the EU and IMF putting together a €750bn support package in mid May. A second crisis, this time over Ireland in November, culminated in Ireland also having to take a bail out. At the time of writing (early January 2011) there is major concern that Portugal will also shortly need to take a bail out. That, in turn, would then stoke major concerns as to whether the current size of the bail out facility put together by the EU and IMF would be big enough to cope with any crisis that then blew up over Spanish government debt.

The unexpectedly high rate of growth in quarters 2 and 3 of 2010 in the UK and the Euro zone in Q2 were driven by strong growth in the construction sector catching up from inclement weather earlier in the year and by other short term factors not expected to be enduring; general expectations are for anaemic (but not negative) growth in 2011 in the western world.

2. UK economy

Following the general election in May 2010, the coalition government has put in place an austerity plan to carry out correction of the public sector deficit over the next five years. The result of fiscal contraction will be major job losses during this period, in particular in public sector services. This is likely to have a knock on effect on consumer and business confidence and appears to have also hit the housing market as house prices started on a generally negative trend starting in mid 2010. Mortgage approvals are also at very weak levels, all of which indicates that the housing market is likely to be weak in 2011.

Economic Growth – GDP growth is likely to have peaked in the current period of recovery at 1.2% in quarter 2 of 2010. Growth in quarter 3 @ +0.7% was also unexpectedly high. However, the outlook is for anaemic growth in 2011/12 although the Bank of England and the Office for Budget Responsibility are forecasting near trend growth (2.5%) i.e. above what most forecasters are currently expecting.

Unemployment – the trend of falling unemployment (on the benefit claimant count) has now been replaced since July 2010 with small increases which may be the start of a new trend for some years ahead of rising unemployment.

Inflation and Bank Rate – CPI has remained high during 2010. It peaked at 3.7% in April and then gradually declined to 3.1% in September (RPI 4.6%). However, the outlook from there is a rising trend which could even reach as much as 4% in early 2011 before starting to subside again. Although inflation has remained stubbornly above the MPC's 2% target, the MPC is confident that inflation will fall back under the target over the next two years.

The Bank of England finished its programme of quantitative easing (QE) with a total of £200bn in November 2009. However, major expectation that there could be a second round of quantitative easing in late 2010 or early 2011, to help support economic growth, has evaporated after the surprises of the Q3 GDP figure of +0.7% and the November Inflation Report revising the forecast for short term inflation sharply upwards.

Sector's central view is that there is unlikely to be any increase in Bank Rate until the end of 2011.

AAA rating – prior to the general election, credit rating agencies had been issuing repeated warnings that unless there was a major fiscal contraction, then the AAA sovereign rating was at significant risk of being downgraded. Sterling was also under major pressure during the first half of the year. However, after the Chancellor's budget on 22 June, Sterling strengthened against the US dollar and confidence has returned that the UK will retain its AAA rating. In addition, international investors viewed UK government gilts as being a safe haven from EU government debt during mid 2010. The consequent increase in demand for gilts helped to add downward pressure on gilt yields and PWLB rates.

3. Sector's forward view

It is currently difficult to have confidence as to exactly how strong UK economic growth is likely to be during 2011/12, and there are a range of views in the market. Sector has adopted a moderate view. There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas:

- the strength / weakness of economic growth in our major trading partners - the US and EU
- the danger of currency war and resort to protectionism and tariff barriers if China does not adequately address the issue of its huge trade surplus due to its undervalued currency
- the degree to which government austerity programmes will dampen economic growth and undermine consumer confidence
- changes in the consumer savings ratio
- the speed of rebalancing of the UK economy towards exporting and substituting imports
- the potential, in the US, for more quantitative easing, and the timing of this , and its subsequent reversal in both the US and UK
- the speed of recovery of banks' profitability and balance sheet imbalances and the consequent implications for the availability of credit to borrowers
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy
- political risks in the Middle East and Korea

The overall balance of risks is weighted to the downside and there is some residual risk of a double dip recession and deleveraging, creating a downward spiral of falling demand, falling jobs and falling prices, although this is currently viewed as being a small risk.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

ANNEX E

MINIMUM REVENUE PROVISION

Report by the Director of Resources

Introduction

1. The Council, at its meeting on 27 June 2008, resolved that the Council's policy for minimum revenue provision (MRP) for 2009/10 be developed in consultation with the Resources PDG and with the Council's external auditor and proposed to the Council in February 2009.

2. This report proposes a policy for minimum revenue provision for the PDG's consideration. The Council's external auditor is also being consulted. The policy will need to be considered by the Executive and by the Council in February. In future, the Council is required to approve a policy for MRP each year.

Background

3. Most councils borrow to fund capital spending. They are required to set aside some of their revenues each year as a provision for debt repayment. The requirement has been that a minimum provision should be calculated as 4% of a council's capital financing requirement – essentially its total debt outstanding.

4. New regulations set a duty for a council to set a minimum revenue provision which " it considers prudent."

Statutory guidance which accompanies the regulations provides options for calculating MRP. The aim is to ensure that debt is repaid over a period reasonably commensurate with the period over which the capital expenditure funded by borrowing provides benefits.

The Council must select and apply one of these options.

MRP options

5. The regulations distinguish between "supported" and "unsupported" borrowing in relation to the options. "Supported" borrowing is borrowing which, theoretically, attracts government support for debt repayment through revenue support grant. "Unsupported" borrowing is funded wholly by individual councils.

The options are described below.

Capital financing requirement method

- MRP is calculated as 4% of the Council's capital financing requirement.
- This method can be applied only to "supported" borrowing.

Depreciation method

- MRP is based on depreciation of the assets acquired
- But may cease to be charged when the total provision made equals the amount borrowed.
- Either the depreciation method or the average life method must be applied to ”unsupported” borrowing.

Average life method

- MRP is made in equal instalments over the estimated life of the assets acquired through borrowing.

6. It is proposed to adopt the average life method for the reasons set out below.

The capital financing requirement method can be applied only to “supported” borrowing. It would therefore need to be combined with one of the other methods for “unsupported” borrowing. The Council uses both “supported” and “unsupported” borrowing and the distinction between the two types has no relevance for the Council. It would be simpler to apply one calculation method for the whole of the Council’s borrowing.

7. The depreciation method, whilst theoretically attractive, introduces some complications. For example, assets must be valued in the Council’s balance sheet at current value and the valuations are updated regularly. MRP provision would change as assets are revalued. Depreciation is not normally applied to land. However, some provision for the repayment of borrowing for the acquisition of land would be necessary. Therefore the depreciation method would need to be combined with the asset life method for land acquisition. It would also be necessary to keep individual accounting records for each item of capital expenditure which would be a substantial additional workload.

8. The average life method is simpler than the depreciation method and is the only method that can be applied to the whole of the Council’s borrowing. It provides a stable and predictable MRP provision which will assist the Council’s budgeting. It is a prudent approach with annual provision for the repayment of debt related directly and clearly to the useful life of the assets acquired through borrowing.

Asset lives

9. The proposed method requires estimates to be made for asset lives. The table below proposes the bases for estimation.

Type of asset	Estimated asset life in years
New capital spending :	
Land	50
Buildings	40
Roads	40
Capital maintenance – buildings	20
Capital maintenance – roads	20
Integrated transport	20
Equipment and vehicles	4
Previous capital spending	25

Impact on the Council's spending

10. The MRP must be charged as part of the Council's revenue spending each year. It may therefore impact on the Council's finances.

The existing provision in the Council's budget is based on a MRP of 4% equivalent to charges made over 25 years.

11. The new annual MRP charges resulting from the proposed policy are likely to be close to this. The average life of assets in the 2007/08 and 2008/09 capital programmes is 24.7 years and 27.2 years respectively It is also proposed to base MRP on an average asset life of 25 years for past capital spending.

The MRP should therefore be met within existing budget proposals.

12. It should also be noted that the MRP is a minimum provision. The Council may, if it wishes, make additional repayments.

Recommendation

The Policy Development Group is asked to support the proposal to adopt the average life method for calculating minimum revenue provision.

ANNEX G

Definition of Credit Ratings and Credit Default Swap Spreads

Credit Ratings:

Long Term Rating (Fitch)

The Long Term rating assesses the borrowing characteristics of banks and the capacity for the timely repayment of debt obligations which apply to instruments of up to 5 years duration.

Long Term Ratings range from AAA, AA, A to DDD, DD, D. Only Institutions with Ratings of AA- and above are acceptable on the Councils Lending List as follows:

AAA - Highest Credit Quality - lowest expectation of credit risk. Exceptionally strong capacity for timely payment of financial commitments. Highly unlikely to be adversely affected by foreseeable events.

AA - Very High Credit Quality - Very low expectation of credit risk. Very strong capacity for timely payment of financial commitments. Not significantly vulnerable to foreseeable events.

"+" Or "-" may be appended to a rating to denote relative status within major rating categories.

Sovereign Ratings (Fitch)

The Sovereign (Governments of Countries) Rating measures a sovereign's capacity and willingness to honour its existing and future obligations in full or on time. It looks at factors such as:

- Macroeconomic performance and prospects;
- Structural features of the economy that render it more or less vulnerable to shocks as well as political risk and governance factors;
- Public finances, including the structure and sustainability of public debt as well as fiscal financing;
- The soundness of the financial sector and banking system, in particular with respect to macroeconomic stability and contingent liability for the sovereign; and
- External finances, with a particular focus on the sustainability of international trade balances, current account funding and capital flows, as well as the level and structure of external debt (public and private).

Sovereign Ratings range from AAA, AA, A to DDD, DD, D. Only countries with a Sovereign Rating AAA are acceptable on the Councils Lending List.

Credit Rating Watches and Outlooks issued by Credit Rating Agencies

Rating Watches -indicate that there is a heightened probability of a rating change in the short term either in a positive or negative direction. A Rating Watch is typically event-driven and, as such, it is generally resolved over a relatively short period.

Rating Outlooks -indicate the direction a rating is likely to move over a one- to two-year period reflecting a position not yet reached but if trends continue will do so hence triggering a rating move.

Money Market Fund Rating (Moodys)

Aaa/MR1+ - this rating denotes the lowest expectation of default risk. It is assigned only in cases of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events. Funds rated MR1+ are considered to have the lowest market risk.

Credit Default Swap (CDS) Spreads

A CDS is effectively a contract between two counterparties to ‘insure’ against default. The higher the CDS price of a counterparty, the higher the supposed risk of default. The CDS level therefore provides a perceived current market sentiment regarding the credit quality of acounterparty and generally the movement in the CDS market gives an early warning of the likely changes in credit ratings of a counterparty.

Sector has employed a benchmark system which compares the CDS spread of a counterparty against a pre-determined benchmark rate (iTraxx Senior Financial Index) to produce a CDS status overlay of ‘In Range’, ‘Monitoring’ or ‘Out of Range’ and this status is used to further determine the creditworthiness of the counterparty.