

**Treasury Management Strategy Statement and Annual Investment Strategy
2013/14**

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 and 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 2011 CIPFA Code of Practice for Treasury Management in the Public Sector, whose key requirements were adopted by the Council in May 2011 as part of Financial Regulations -Section C. This Code and the Prudential Code were revised by CIPFA in 2012, for some minor amendments to Prudential Indicators. These amendments are detailed in paragraph 2.5.3 of this report.

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 2013/2014 as Section 2 and the Annual Investment Strategy for 2013/2014 as Section 3 and has been prepared in accordance with the CIPFA Code of Practice for Treasury Management 2011.

1.3.1.1. Treasury Management Strategy Statement 2013/2014

The Treasury Management Strategy Statement is an annual statement that sets out the expected treasury activities for the forthcoming year 2013/2014.

1.3.1.2. The Annual Investment Strategy 2013/2014

The Annual Investment Strategy sets out the Council's policies for investing its surplus cash for the year 2013/2014 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 2013/2014

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 2013/2014 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 long term external borrowing/investment position;
- Borrowing requirement 2012/2013 to 2014/2015;
- Affordable borrowing limit for 2013/14 to 2015/16;
- Prudential indicators 2013/2014 to 2015/2016;
- Prospect for interest rates 2013/2016;
- Long term borrowing strategy 2013/2014;
- Debt rescheduling opportunities;
- Investment strategy 2013/2014;
- Short term (cash flow) borrowing strategy 2013/2014;
- Other current treasury issues.

2.2. Current Long Term External Borrowing & Investment Position

2.2.1. In order to place the Treasury Management Strategy in context, the Council's treasury portfolio position at 31.12.2012 comprised:

		Principal £million	Ave Rate %
Long Term Borrowing			
Opening Balance	31.3.12	450.515	4.153
New Borrowing to	31.12.12	12.000	3.173
Borrowing Repaid to	31.12.12	(6.354)	
Rescheduling:			
Borrowing Repaid Early to	31.12.12	0.0	
Borrowing Replaced	31.12.12	0.0	
Total Borrowing at	31.12.12	456.161	4.135
Investments			
LCC at	31.12.12	208.774	
Pension Fund at	31.12.12	2.786	
Total Investments at	31.12.12	211.560	1.101
Net Borrowing at	31.12.12	244.601	

2.3. Long Term Borrowing Requirement 2012/2013 to 2014/2015

2.3.1. The long term borrowing requirement for 2012/2013 to 2014/2015, as detailed in the Council Budget 2013/14 -2014/15 Report, which is to be considered by the County Council at its meeting on the 22nd February 2013, is as follows:

Long Term Borrowing Requirement	2012/13 £m	2013/14 £m	2014/15 £m	Total £m
New Borrowing	72.057	91.214	72.372	235.643
Replacement Borrowing	6.354	3.354	11.354	21.062

2.3.2. It is intended that around £40m of the 2012/13 borrowing requirement will be met by internal resources, not external borrowing, hence further lowering actual external borrowing below the Council's Capital Financing Requirement (CFR), a Prudential Indicator, which is a measure of the Council's underlying borrowing need.

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

2.4. Affordable Borrowing Limit for 2013/2014 to 2015/2016

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 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 2013/14 to 2015/16 has been set as follows: -

	2013/14 £million	2014/15 £million	2015/16 £million
Borrowing	602.729	648.924	652.673
Other Long Term Liabilities	17.126	16.321	15.481
TOTAL	619.855	665.245	668.154

2.4.5. The Assistant Director of Resources – 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 2013/2014 to 2015/2016

2.5.1. Annex A 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 Council Budget 2013/14 -2014/15 Report, which is to be considered at the meeting of the County Council on 22nd February 2013.

2.5.3. Following a minor revision to the CIPFA Code of Practice for Treasury Management and the CIPFA Prudential Code in 2012, the new Treasury Indicator '**upper limit for net debt expressed as a percentage of gross debt**' introduced last year, has been removed as it was not achieving its intended purpose of controlling the level of borrowing undertaken in advance of need. The Prudential Code's '**net debt and the capital financing requirement indicator**' has been replaced with a '**gross debt and the capital financing requirement indicator**'. Using gross debt without netting off investment balances was thought a better measure to ensure that a Council's debt does not exceed the capital financing requirement in the long term, i.e. borrowing undertaken is for a capital purpose only.

2.6. Prospect for Interest Rates 2013-2016

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. Annex B 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.

Annual Average %	Bank Rate	Money Rates		PWL B Borrowing Rates		
		3 month	1 year	5 year	25 year	50 year
Dec 2012	0.50	0.50	1.00	1.50	3.70	3.90
Mar 2013	0.50	0.50	1.00	1.50	3.80	4.00
June 2013	0.50	0.50	1.00	1.50	3.80	4.00
Sept 2013	0.50	0.50	1.00	1.60	3.80	4.00
Dec 2013	0.50	0.50	1.00	1.60	3.80	4.00
Mar 2014	0.50	0.50	1.10	1.70	3.90	4.10
June 2014	0.50	0.60	1.10	1.70	3.90	4.10
Sept 2014	0.50	0.60	1.20	1.80	4.00	4.20
Dec 2014	0.50	0.70	1.30	2.00	4.10	4.30
Mar 2015	0.75	0.80	1.30	2.20	4.30	4.50
Jun 2015	1.00	1.10	1.50	2.30	4.40	4.60
Sept 2015	1.25	1.40	1.80	2.50	4.60	4.80
Dec 2015	1.50	1.70	2.10	2.70	4.80	5.00
Mar 2016	1.75	1.90	2.40	2.90	5.00	5.20

Economic Commentary

2.6.2. The economic recovery in the UK since 2008 has been the worst and slowest recovery in recent history, although the economy returned to positive growth in the third quarter of 2012. Growth prospects are weak and consumer spending, the usual driving force of recovery, is likely to remain under pressure due to consumers focusing on repayment of personal debt, inflation eroding disposable income, general malaise about the economy and employment fears.

2.6.3. The primary drivers of the UK economy are likely to remain external. 40% of UK exports go to the Euro zone so the difficulties in this area are likely to continue to hinder UK growth. The US, the main world economy, faces similar debt problems to the UK, but urgently needs to resolve the fiscal cliff now that the Presidential elections are out of the way. The resulting US fiscal tightening and continuing Euro zone problems will depress UK growth and is likely to see the UK deficit reduction plans slip.

2.6.4. A more detailed view of the current economic outlook is contained within Annex C to this report.

2.6.5. This challenging and uncertain economic outlook has several key treasury management implications:

- The Eurozone sovereign debt difficulties provide a clear indication of high counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;

- Investment returns are likely to remain relatively low during 2013/14 and beyond;
- Borrowing interest rates continue to be attractive, but may remain relatively low for some time. The timing of any borrowing will need to be monitored carefully;
- There will remain a cost of carry – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

2.7. Long Term Borrowing Strategy 2013/2014

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. Long term rates are difficult to predict for reasons already stated with the likelihood that they will rise only very gradually in 2013/14. Suggested target rates are as follows: 50 yr 4.20%, 25 yr – 4.10%, 10yr – 2.90% and 5 yr – 1.80%.

2.7.1.2. The Council's Long Term Borrowing Maturity Profile as at 26th February 2013 can be seen as Annex D. It shows that there is a gap in the maturity profile between 17 years and 40 years which any new maturities should focus on at prevailing rates of interest.

2.7.1.3. Market loans and LOBO¹ loans may be available at rates below PWLB rates. However an appropriate balance between PWLB and market debt should be maintained in the debt portfolio.

2.7.1.4. 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 Council is currently maintaining an 'under-borrowed' position, given its decision not to borrow externally in 2011/12 and only to a limited extent in 2012/13. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with external debt, and internal balances and cash flow has been used instead as a temporary measure (referred to as internal borrowing). This strategy is prudent as investment returns are low and counterparty risk is high.

2.7.3. The table below shows the comparison between the Council's gross and net debt positions at the year end from 2010/11 to 2014/15.

Comparison of gross and net debt at year end	2011/12 Actual	2012/13 Probable Outturn	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
	£m	£m	£m	£m	£m
Actual External Debt (Gross)	450.515	460.853	527.706	574.378	583.836
Cash Balances (Investments)	236.970	108.941	95.941	83.941	83.941
Net Debt	213.545	351.912	431.765	490.437	499.895
Net Debt as % of Gross Debt	47.4%	76.4%	81.8%	85.4%	85.6%

2.7.4. The table shows that the difference between gross and net debt is the level of investments held by the Council. It shows that the level of investments should fall in 2012/13 onwards, reflecting the internal borrowing strategy taken and use of balances planned for 2013/14 and 2014/15, to a level whereby opportunities for further internal borrowing are limited in order to maintain adequate balances for liquidity/cash flow requirements.

Minimum Revenue Provision / Repayment of Debt

2.7.5. 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.

2.7.6. 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 Annex E.

2.7.7. 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

2.7.8. 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.
- limit borrowing in advance to no more than 25% of the expected increase in borrowing need (CFR) over the three year planning period. (Voluntary Prudential Indicator).

2.7.9. Given the factors detailed in 2.7 above, the following borrowing strategy will be adopted for 2013/14:

The Council will take new borrowing from the PWLB in all periods with the aim of achieving an even spread of maturity profile and avoiding an increase in the average cost of the Council's debt. Target levels will be monitored and timing of borrowing taken will coincide with any reduced rate opportunity below the target levels identified.

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 LOBOs.

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 2.7.8 above.

2.7.10. 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 EIP² loans into PWLB maturity³ loans. At the time of writing £23.0 million of EIP debt, from the Council's total debt portfolio of £456.2 million, remains to be rescheduled given the opportunity.

2.8.4. Interest savings may also be achievable in 2013/14 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 premium⁴ or discount⁵ 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 2013/14 by the Council and Sector Ltd. However, PWLB to PWLB debt restructuring is now much less attractive because of the large premiums that would be incurred due to the introduction by the PWLB in 2007 of a spread between the rates applied to new borrowing and repayment of debt.

2.9. Investment Strategy 2013/2014

2.9.1. Bank Rate is expected to remain unchanged at 0.50% for 2013/14. There is downside risk to this forecast if recovery from the recession proves to be weaker and slower than currently expected.

2.9.2. Given the current concerns over the economic environment, it is prudent to keep investments relatively short (no longer than 1 year) with good quality counterparties, whilst market uncertainty continues.

2.9.3. The Council's investment level is forecast to fall to around £100-£150 million net of Pension Fund cash from 2013/14, (ignoring any underspend in capital and revenue budgets in 2012/13), of which around £50 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.

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.

2.9.4. The Council's investment priorities are:

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

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.

2.9.5. Given these factors above, the following investment strategy will be adopted for 2013/14:

For the element of the Council's investment portfolio that represents 'core' balances, 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. In accordance with Sector's advice, the 3 month duration cap placed on investments to all counterparties other than part-nationalised UK banks has been lifted, in light of improved market conditions. 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. Extensive use of Bank Business Reserve Accounts and Money Market Funds⁶ will be made, that offer returns close to or in excess of base rate level, for the Council's 'core' cash and cash flow generated balances. The target investment return for investments for 2013/14 is the weighted 7 day/3 month LIBID benchmark adopted that reflects the risk parameters of the investment portfolio. This is a relative benchmark which moves with the markets, but as an indication the benchmark rate at 31st December 2012 was 0.54%.

Short term investment in Certificates of Deposit⁷ and Treasury Bills⁸ 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.

2.9.6. 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.

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.

2.9.7. 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 Council's approved counterparty investment list.

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

2.10. Short Term (Cash Flow) Borrowing Strategy 2013/2014

2.10.1. During 2013/2014, 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 2013/14
Long Term Borrowing from the PWLB on behalf of schools as part of the schools loan scheme will be undertaken throughout 2013/2014 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 2013/2014 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.

3. ANNUAL INVESTMENT STRATEGY 2013/2014

- 3.1. In accordance with Section 15(1) of the Local Government Act 2003, Lincolnshire County Council has adhered to the Guidance on Local Government Investments issued by the Secretary of State, and as such has produced its Annual Investment Strategy for 2013/2014 detailed below.
- 3.2. The Council's investment priorities will be security first, liquidity second, and then return. The intention of the Strategy is to provide security of investment and minimisation of risk. The aim of the Strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk. Investment instruments identified for use in 2013/2014 under Specified and Non-Specified investment categories are detailed below.

3.3. Specified Investments

3.3.1. In accordance with CLG Guidance on Local Government Investments, 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 and including 12 months (such investments to include fixed, callable or forward term deposits as appropriate⁹, 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: -

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.

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 (Excluding UK)
	Green	
Money Market Funds		Long Term Rating (Moody's): Aaa/MR1+ or (Fitch): AAA or (S & P): AAAm

+For definition of credit ratings see Annex F.

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 Annex F for definition.
- Credit default swap (CDS) spreads to give early warning of likely changes in credit ratings – see Annex F 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. Rating Agency information and CDS spreads are monitored on a real time basis with knowledge of any changes sent electronically by Sector as soon as they are detected. 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.

Additional Minimum Rating Criteria/Limits in Place –set by Council

In addition to the Sector creditworthiness recommendations, the Council has also set further minimum credit requirements that restrict the number of acceptable counterparties further and is therefore deemed prudent.

- A minimum Sovereign (Country) Rating from Fitch of AAA (excluding the UK).
- A minimum Long Term Rating from Fitch of AA-.
- A limit of a maximum of no more than 20% of total investments to be placed with any one bank/group or building society sector - to ensure diversification of investments. (With exception of Part UK Nationalised Banks which are deemed to bear same low risk as UK Government).

Barclays Bank do not at present meet the Council's AA- minimum requirement and so are not on the Authorised Lending List. However Barclays Bank was appointed as the Council's bankers in April 2012 and therefore the Council does have a minimum financial exposure to Barclays on a daily basis. When it is not financially viable to make an investment, a cash balance will be left at the bank overnight, so long as Barclays Bank remain on Sector's recommended Counterparty list.

Duration and Limits

From the above methodology the following duration and amount limits have been assigned to each colour band. With Council balances due to fall as a result of falling reserves and internal borrowing, maximum amount limits have been assigned to different levels of balances as shown in the table below. This is a new approach which allows the Council to be more risk sensitive to falling balances going forward.

Sector Weighted Colour Band	Maximum Duration	Maximum Amount Based on Average Balance of		
		£200m	£150m	£100m
Blue***	1 Year	£40m	£30m	£25m
Orange	1 Year	£20m	£20m	£15m
Red	6 Months	£15m	£10m	£10m
Green	3 Months	£10m	£5m	£5m

*** Applies to nationalised or semi nationalised UK Banks:-

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 and will continue to do so as long as they remain semi nationalised.

3.3.2. The Assistant Director of Resources –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 benchmark¹⁰ and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or suspension from the Council’s lending list.

3.3.3. 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.

3.4. Non-Specified Investments

3.4.1. In accordance with CLG Guidance on Local Government 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.

3.4.2. Having assessed the acceptable level of risk involved in all non-specified investments, it is the decision of the Assistant Director of Resources- 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).

¹⁰ iTraxx Senior Financials Index that measures the “average” level of the most liquid financial CDS prices in the CDS market.

3.4.3. 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 Colour Band	Credit	Minimum Acceptable Credit Rating +
Bank or Building Society	Purple		Long Term Rating (Fitch): AA-
			Sovereign Rating (Fitch): AAA (Excluding UK)

+ For definition of credit ratings see Annex F.

The following duration and amount limits have been assigned to this colour band based on averages balances, (new risk sensitive approach), as follows:

Sector Weighted Colour Band	Maximum Duration	Maximum Amount Based on Average Balance of		
		£200m	£150m	£100m
Purple	2 Years	£25m	£20m	£15m

3.4.4. 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.

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

3.5. Additions to Non-Specified Investment List

3.5.1. 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 of Resources – Finance & Resources, a recommendation for the change to the Annual Investment Strategy will be sought from the Executive Councillor with responsibility for finance.

3.6. Liquidity of Investments

3.6.1. 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.

3.7. Training Needs for Treasury Management Staff

3.7.1. The importance of ensuring that all staff involved in the treasury management function are fully equipped to undertake the duties and responsibilities allocated to them are recognised by the Council. Consequently, the Council seeks to appoint individuals who are both capable and suitably experienced and also will provide training for staff to enable them to acquire and maintain an appropriate level of expertise, knowledge and skills.

3.7.2. All treasury management staff are encouraged to take any suitable training in treasury management provided by CIPFA, Sector Ltd or other relevant market participant. Both the Treasury Manager and Treasury Officer for the Council have successfully gained the qualification. CIPFA/ACT qualification in 'International Treasury Management (Public Finance)'.

ANNEX A

PRUDENTIAL INDICATORS:	2012/13	2013/14	2014/15	2015/16
Affordability:				
Increase in council tax levels	£2.58	£22.78	£20.27	£17.05
Ratio of Net Financing Costs to Net Revenue Stream	6.28%	6.66%	7.46%	7.76%
Ratio of MRP & Interest Payments to Net Revenue Stream -10% limit (Voluntary Indicator)	6.35%	6.61%	7.43%	7.90%
	£m	£m	£m	£m
Capital Expenditure:				
Capital Financing Requirement CFR (as at 31 March)	561.464	626.383	671.108	678.761
Gross External Borrowing Forecast	463.853	527.706	574.378	583.836
TREASURY INDICATORS (within the Prudential Code):				
<u>Authorised limit for external debt -</u>				
Borrowing	543.315	602.729	648.924	652.673
Other long term liabilities	23.220	17.126	16.321	15.481
TOTAL	566.535	619.855	665.245	668.154
<u>Operational boundary -</u>				
Borrowing	519.315	578.729	624.924	628.673
Other long term liabilities	21.220	15.126	14.321	13.481
TOTAL	540.535	593.855	639.245	642.154
TREASURY INDICATORS (with the TM Code):				
<u>Gross and Net Debt</u>				
Borrowing in advance of need limited to percentage of the expected increase in CFR over the 3 year budget period. (Voluntary Indicator)	25%	25%	25%	25%
	£m	£m	£m	£m
<u>Upper limit for fixed interest rate exposure</u>				
Net principal re fixed rate borrowing less investments	678.761	678.761	678.761	678.761
	£m	£m	£m	£m
<u>Upper limit for variable rate exposure</u>				
Net principal re variable rate borrowing less investments	203.628	203.628	203.628	203.628
	£m	£m	£m	£m
<u>Upper limit for total principal sums invested for over 364 days (per maturity date)</u>	40.000	40.000	40.000	40.000
<u>Maturity structure of new fixed rate borrowing during 2012/13</u>	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%	

Interest Rate Forecast 2013-2016

ANNEX B

Sector's Interest Rate View															
	Now	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
3 Month LIBID	0.40%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.60%	0.60%	0.70%	0.80%	1.10%	1.40%	1.70%	1.90%
6 Month LIBID	0.56%	0.70%	0.70%	0.70%	0.70%	0.70%	0.70%	0.80%	0.90%	1.00%	1.10%	1.30%	1.60%	1.90%	2.20%
12 Month LIBID	0.92%	1.00%	1.00%	1.00%	1.00%	1.00%	1.10%	1.10%	1.20%	1.30%	1.30%	1.50%	1.80%	2.10%	2.40%
5yrPW IB Rate	1.66%	1.50%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
10yrPW IB Rate	2.64%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
25yrPW IB Rate	3.88%	3.70%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
50yrPW IB Rate	4.04%	3.90%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
Bank Rate															
Sector's View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
UBS	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
Capital Economics	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
5yrPW IB Rate															
Sector's View	1.66%	1.50%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
UBS	1.66%	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	1.66%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.50%	1.60%	-	-	-	-	-
10yrPW IB Rate															
Sector's View	2.64%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
UBS	2.64%	2.80%	3.00%	3.10%	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	-	-	-	-	-
Capital Economics	2.64%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	-	-	-	-	-
25yrPW IB Rate															
Sector's View	3.88%	3.70%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
UBS	3.88%	4.00%	4.20%	4.30%	4.40%	4.50%	4.50%	4.50%	4.50%	4.50%	-	-	-	-	-
Capital Economics	3.88%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	-	-	-	-	-
50yrPW IB Rate															
Sector's View	4.04%	3.90%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
UBS	4.04%	4.10%	4.30%	4.40%	4.50%	4.60%	4.60%	4.60%	4.60%	4.60%	-	-	-	-	-
Capital Economics	4.04%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	-	-	-	-	-

Economic Background – Source Sector Treasury Services Ltd

1. The Global economy

The Eurozone debt crisis has continued to cast a pall over the world economy and has depressed growth in most countries. This has impacted the UK economy which is unlikely to grow significantly in 2012 and is creating a major headwind for recovery in 2013. Quarter 2 of 2012 was the third quarter of contraction in the economy; this recession is the worst and slowest recovery of any of the five recessions since 1930. A return to growth @ 1% in quarter 3 is unlikely to prove anything more than a washing out of the dip in the previous quarter, before a return to weak, or even negative, growth in quarter 4.

The **Eurozone sovereign debt crisis** has abated somewhat following the ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bailout. The immediate target for this statement was Spain which continues to prevaricate on making such a request (for a national bailout) and so surrendering its national sovereignty to IMF supervision. However, the situation in Greece is heading towards a crunch point as the Eurozone imminently faces up to having to relax the time frame for Greece reducing its total debt level below 120% of GDP and providing yet more financial support to enable it to do that. Many commentators still view a Greek exit from the Euro as inevitable as total debt now looks likely to reach 190% of GDP i.e. unsustainably high, unless the Eurozone were to accept a major write down of Greek debt. The possibility of a write down has now been raised by the German Chancellor, but not until 2014-15, and provided the Greek annual budget is in balance.

Sentiment in financial markets has improved considerably since this ECB action and recent Eurozone renewed commitment to support Greece and to keep the Eurozone intact. However, the foundations to this "solution" to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse.

The US economy has only been able to manage weak growth in 2012 despite huge efforts by the Federal Reserve to stimulate the economy by liberal amounts of quantitative easing (QE) combined with a commitment to a continuation of ultra low interest rates into 2015. Unemployment levels have been slowly reducing but against a background of a fall in the numbers of those available for work. The fiscal cliff facing the President at the start of 2013 has been a major dampener discouraging business from spending on investment and increasing employment more significantly in case there is a sharp contraction in the economy in the pipeline. However, the housing market does look as if it has, at long last, reached the bottom and house prices are now on the up.

Hopes for a broad based recovery have, therefore, focused on the **emerging markets**. However, there are increasing concerns over flashing warning signs in

various parts of the Chinese economy that indicate it could be in risk of heading for a hard landing rather than a gradual slow down.

2. The UK economy

The Government's austerity measures, aimed at getting the public sector deficit into order, have now had to be extended in the autumn statement over a longer period than the original four years. Achieving this new extended time frame will still be dependent on the UK economy returning to a reasonable pace of growth towards the end of this period. It was important for the Government to retain investor confidence in UK gilts so there was little room for it to change course other than to move back the timeframe.

Currently, the UK is enjoying a major financial benefit from some of the lowest sovereign borrowing costs in the world as the UK is seen as a safe haven from Eurozone debt. There is, though, little evidence that consumer confidence levels are recovering nor that the manufacturing sector is picking up. On the positive side, growth in the services sector rebounded in Q3 and banks have made huge progress since 2008 in shrinking their balance sheets to more manageable levels and also in reducing their dependency on wholesale funding. However, availability of credit remains tight in the economy and the Funding for Lending scheme, which started in August 2012, has not yet had time to make a significant impact. Finally, the housing market remains tepid and the outlook is for house prices to be little changed for a prolonged period.

Economic Growth. Economic growth has basically flat lined since the election of 2010 and, worryingly, the economic forecasts for 2012 and beyond were revised substantially lower in the Bank of England Inflation quarterly report for August 2012 and were then further lowered in the November Report. Quantitative Easing (QE) was increased again by £50bn in July 2012 to a total of £375bn. Many forecasters are expecting the MPC to vote for a further round of QE to stimulate economic activity regardless of any near-term optimism. The announcement in November 2012 that £35bn will be transferred from the Bank of England's Asset Purchase Facility to the Treasury (representing coupon payments to the Bank by the Treasury on gilts held by the Bank) is also effectively a further addition of QE.

Unemployment. The Government's austerity strategy has resulted in a substantial reduction in employment in the public sector. Despite this, total employment has increased to the highest level for four years as over one million jobs have been created in the private sector in the last two years.

Inflation and Bank Rate. Inflation has fallen sharply during 2012 from a peak of 5.2% in September 2011 to 2.2% in September 2012. However, inflation increased back to 2.7% in October though it is expected to fall back to reach the 2% target level within the two year horizon.

AAA rating. The UK continues to enjoy an AAA sovereign rating. However, the credit rating agencies will be carefully monitoring the rate of growth in the economy as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years.

3.Sector's forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains relatively fragile and whilst there is still a broad range of views as to potential performance, expectations have all been downgraded during 2012. Key areas of uncertainty include:

- the potential for the Eurozone to withdraw support for Greece at some point if the Greek government was unable to eliminate the annual budget deficit and the costs of further support were to be viewed as being prohibitive, so causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- inter government agreement on how to deal with the overall Eurozone debt crisis could fragment; the impact of the Eurozone crisis on financial markets and the banking sector;
- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to manufactured goods;
- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that are unlikely to be achieved;
- the risk of the UK's main trading partners, in particular the EU and US, falling into recession ;
- stimulus packages failing to stimulate growth;
- elections due in Germany in 2013;
- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.
- the potential for action to curtail the Iranian nuclear programme
- the situation in Syria deteriorating and impacting other countries in the Middle East

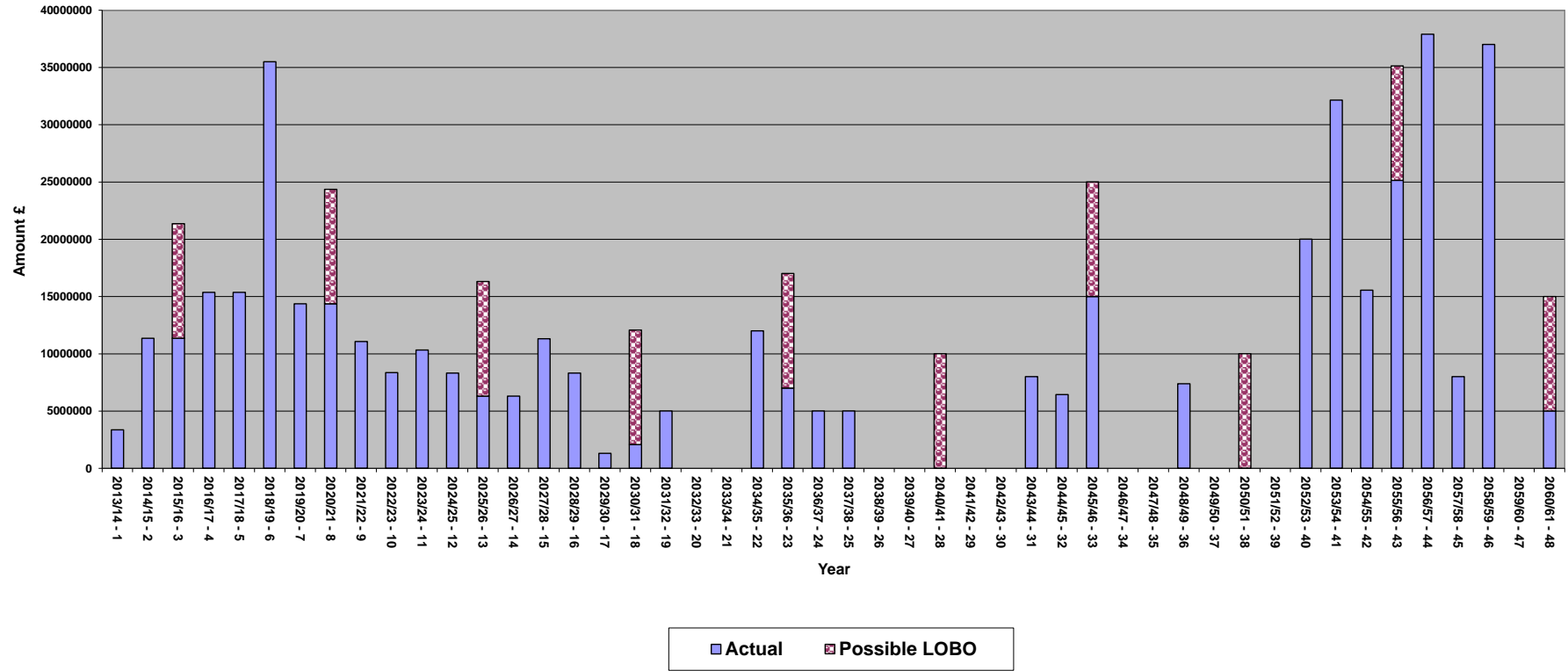
The focus of so many consumers, corporates and banks on reducing their borrowings, rather than spending, will continue to act as a major headwind to a return to robust growth in western economies.

Given the weak outlook for economic growth, Sector sees the prospects for any changes in Bank Rate before 2015 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

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. The interest rate forecast in this report represents a balance of downside and upside risks. The downside risks have already been commented on. However, there are specific identifiable upside risks as follows to PWLB rates and gilt yields, and especially to longer term rates and yields: -

- UK inflation being significantly higher than in the wider EU and US causing an increase in the inflation premium in gilt yields
- Reversal of QE; this could initially be allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held
- Reversal of Sterling's safe haven status on an improvement in financial stresses in the Eurozone
- Investors reverse de-risking by moving money from government bonds into shares in anticipation of a return to worldwide economic growth
- The possibility of a UK credit rating downgrade (Moody's has stated that it will review the UK's Aaa rating at the start of 2013).

Long Term Borrowing Maturity Profile at 26-2-2013



Resources Policy Development Group
12 January 2009

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.

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 (Moody's)

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 a counterparty 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.