St Edmundsbury
BOROUGH COUNCIL

A496

Cabinet
10 February 2010

Treasury Management Performance and Annual Treasury Management and Investment Strategy 2010/2011

1. Summary and Reasons for Recommendations

1.1 The Council's Treasury Management activities generate a substantial amount of income and therefore warrant regular Member consideration. The purpose of this report is to:-

(a) provide an update on Treasury Management activity and performance for the period 1 April to 31 December 2009;

(b) seek Cabinet and Council approval for the adoption of the revised Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services Code of Practice 2009, as detailed in Appendix 1 to this report;

(c) seek Cabinet and Council approval to the principle of establishing a Treasury Management Sub-Committee of the Performance and Audit Scrutiny Committee to fulfil the enhanced scrutiny requirements of the new Code; and

(d) seek Cabinet and Council approval for the Annual Treasury Management and Investment Strategy Statements for 2010/2011 and Prudential Indicators, as detailed in Appendix 2 to this report.

1.2 The budget for investment income in 2009/2010 is £751,000, equivalent to £19.87 for each Council Tax Band D property. At the end of December 2009 interest earned amounted to £893,554 against the budget for the period of £602,925, a budget surplus for the period of £290,629.

1.3 In the light of the recent banking crisis, CIPFA has issued a revised Treasury Management in the Public Services Code of Practice (the Code). Compliance with the Code requires that it is formally adopted by full Council, together with four revised treasury management clauses, for inclusion within the Council's Constitution. Full details of the requirements of the revised Code are provided at Appendix 1.

1.4 The proposed Treasury Management and Investment Strategy Statements for 2010/2011, attached as Appendix 2, set out the Council's treasury management policies and strategies for the forthcoming year. It is a requirement of the Code that these strategy statements are approved by full Council prior to the start of the financial year.

1.5 It is estimated that in 2010/2011 Treasury Management activity will generate income of £566,000 (which is equivalent to £14.91 for each Council Tax Band D property). This represents an average target investment rate for the year of 1.5% and reflects current projections regarding interest rate movements in the forthcoming year. Appendix 3 provides a summary of the national and international forecasts provided by the Council's treasury management advisors, Sector Treasury Services Limited, which support these estimates.

1.6 In addition to interest income derived from the investment of the Council's balances, it is estimated that the Council's Non Operational Property and Assets Portfolio will generate income of £2,680,000 during the year (which is equivalent to £70.60 for each Council Tax Band D property).

2. Recommendations

2.1 Information on the performance of the Treasury Management function for the period 1 April to 31 December 2009 contained within this report be noted.

2.2 Subject to the approval of full Council, it is **RECOMMENDED** that:-

(a) the revised Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Service Code of Practice 2009 and associated treasury management clauses, for inclusion in the Council's Constitution, as detailed in Appendix 1 to Report A496, be formally adopted; and

(b) the Annual Treasury Management Strategy Statement and Annual Investment Strategy for 2010/2011 together with the Prudential Indicators, as detailed in Appendix 2 to Report A496, be approved; and

(c) subject to the approval of the Performance and Audit Scrutiny Committee, a Treasury Management Sub-Committee of the Performance and Audit Scrutiny Committee be established in principle, to fulfil the enhanced scrutiny requirements of the new Code.

3. Corporate Objectives

3.1 The recommendations meet the following, as contained within the Corporate Plan:-

(a) Corporate Priority: *'To raise corporate standards and efficiency'*; and
(b) Cabinet Commitments: *'Improving Efficiency and Value for Money'.*

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4. Key Issues

4.1 Treasury Management Performance: 1 April to 31 December 2009

4.1.1 The Council's Treasury Management activities generate a substantial amount of income and therefore warrant regular Member consideration. The Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management requires that Members receive regular progress reports on treasury management activity.

4.1.2 **Investment Position**: The total amount invested at 1 April 2009 was £46.44m, at 30 September 2009 was £47m, and at 31 December 2009 was £46.55m. It should be noted that the Council has never held funds with any Icelandic banks and so has not been affected by the collapse of that country's banking system. The Council's treasury management advisors, Sector Treasury Services Limited, are continuing to provide on-going advice on the creditworthiness of individual financial institutions based upon the latest assessments provided by the Fitch, Moody and Standard and Poors credit rating agencies. In addition, the Council's investment strategy seeks to minimise the risks associated with fluctuations in interest rates and the potential collapse of individual financial institutions, by spreading funds across a range of organisations for varying durations at fixed rates of interest.

4.1.3 The budget for investment income for the 2009/2010 financial year is £751,000, equivalent to £19.87 for each Council Tax Band D property. At the end of December 2009 interest earned amounted to £893,554 against the budget for the period of £602,925, a surplus of £290,629. The over achievement of interest on investments during this period was due to higher than expected interest rates (representing £64,193) and to slippage on the capital programme and other cash flow advantages (representing £226,436). The target investment rate for the year is 2.2%. In the nine month period covered by this report, the average rate of interest achieved has been 2.43%. Furthermore, as at 31 December 2009 only £10,777,000 had been spent out of the full year's original capital programme budget of £26,650,000.

4.1.4 **Interest Rate Fluctuations**: The target investment rate of 2.2% was set in February 2009 as part of the budget process. This was based on interest rate projections provided by Sector Treasury Services Limited, together with consideration of the returns being achieved on the Council's portfolio of fixed term investments. Base rates, which during the period April 2008 to February 2009 had fallen from 5% to 1%, fell still further in March 2009 to just 0.5%, an historic low, and have remained at this level throughout the financial year to date. Sector Treasury Services Limited currently project that during 2010/2011 base rates will remain at 0.5% until the third quarter of the financial year, rising slowly to 1.5% by the year end.

4.1.5 In view of latest interest rate projections and estimates of spending on capital projects and receipts from the sale of assets, it is expected that the current level of budget surplus on investment returns will be maintained during the remainder of this financial year.

4.2 Adoption of the Revised CIPFA Treasury Management Code of Practice 2009

4.2.1 **Requirements of the Revised Code:** The CIPFA Code of Practice on Treasury Management in Local Authorities was last updated in 2001 (adopted by the Council in March 2002) and has been revised in 2009 in the light of the international banking crisis; including the collapse of the Icelandic banks in 2008. A summary of the key areas covered within the revised Code is provided at Appendix 1.

4.2.2 The revised Code requires the Council to formally adopt four amended treasury management clauses for inclusion within its Constitution document. Details of the required clauses are included at Appendix 1. The revised Code also includes an amended version of the Treasury Management Policy Statement (TMPS) and a revised definition of treasury management activities. These requirements have been incorporated within the revised Treasury Management and Investment Strategy at Appendix 2.

4.2.3 **Revised Treasury Management Reporting Arrangements:** Compliance with the Code requires changes to the Council's current Treasury Management reporting and scrutiny arrangements, which will need to come into effect from the 2010/2011 financial year. In particular the Code requires the involvement of Council's scrutiny and audit committees in the scrutiny of the treasury management function. It is considered that this enhanced scrutiny role is best served through the establishment of a Treasury Management Sub-Committee of the Performance and Audit Scrutiny Committee, which can develop the detailed knowledge required to effectively scrutinise this specialist finance function. The Sub-Committee would receive quarterly treasury management performance reports which would also incorporate, as appropriate, the annual treasury management and investment strategy reports, the annual outturn report and mid year review. The Code also requires that full Council receives the annual outturn report (currently only considered by the Cabinet) and a new mid year treasury management review report. A summary of current and revised treasury management reporting arrangements are provided at Appendix 1.

4.3 Annual Treasury Management and Investment Strategy: 2010/2011

4.3.1 The CIPFA Code of Practice requires that a treasury management and investment strategy is approved by the Council prior to the beginning of the financial year to which it relates. The proposed Treasury Management and Investment Strategy Statements for 2010/2011, attached as Appendix 1 to this report, meets the requirements of the CIPFA Code together with the Department for Communities and Local Government's (DCLG) Guidance on Local Government Investments and the statutory requirements of the Local Government Act 2003 (relating to the need to set Prudential Indicators to ensure that the Council's capital investment plans are affordable, prudent and sustainable). The strategies give priority to the security and liquidity of investments whilst at the same time seeking to achieve value for money in treasury management. They also seek to give maximum flexibility in terms of the usage of fixed and variable rate investments and allow for the balancing of certainty of income arising from fixed term investments with the need to retain a core balance that can be easily liquidated should the need arise.

4.3.2 The strategy confirms the Council's debt free status and indicates that there are no plans to borrow monies for capital purposes in the foreseeable future. Within this overall strategy the Head of Finance may approve short term borrowings (less than 12 months in duration) to provide for day to day cash flow management. This does not affect the Council's debt free status.

4.3.3 It is estimated that in 2010/2011 Treasury Management activity will generate income of £566,000 (which is equivalent to £14.91 for each Council Tax Band D property). This represents an average target investment rate for the year of 1.5%. The considerable reduction in investment income compared to the 2009/2010 estimate (i.e. investment income of £751,000, equivalent to £19.87 for each Council Tax Band D property) takes into account:-

(a) the latest projections regarding the continuation of historic low interest rates;
(b) the maturity dates for the Council's current fixed term investments (all of which

have been paying higher rates than are now available); and

(c) the reduction in Council balances arising from the impact of the Council's capital expenditure plans and reducing asset disposals programme.

4.3.4 Appendix 3 provides a summary of the national and international forecasts provided by the Council's treasury management advisors (Sector Treasury Services Limited) which support the underlying interest rate projections used in the preparation of these estimates.

4.4 **Property Portfolio**

4.4.1 The Council also owns a portfolio of non-operational property and assets which are managed on firm estates management and asset management principles. Its capital value as at 31 March 2009 was £25,160,000. It is estimated that in 2010/2011 this will generate income of £2,680,000, equivalent to £70.60 for each Council Tax Band D property.

4.4.2 The Council continually reviews its portfolio to ensure the individual assets are performing in terms of financial return, service return and value for money. Properties which do not meet the criteria may be declared surplus and sold, or actively managed with partners where this option will result in better performance.

5. Other Options considered

5.1 In the past the Council has employed fund managers to look after its major investments, but returns were consistently less than those achieved through the in-house management of funds.

6. Community impact *(including Section 17 of the Crime and Disorder Act 1998 and diversity issues)*

6.1 General The level of interest earned on investments reduces the demand on the Council Tax payer to fund the cost of service provision.

6.2 Diversity All Council Tax payers in the St Edmundsbury area will benefit from the interest achieved on investments.

7. Consultation

7.1 Consultation has been undertaken with the Portfolio Holder for Resources and Efficiency, the Corporate Management Team and the Management Team.

8. Resource implications *(including asset management implications)*

It is estimated that in 2010/2011 Treasury Management activity will generate income of £566,000 (which is equivalent to £14.91 for each Council Tax Band D property) and the Council's non operational property and assets portfolio will generate income of £2,680,000 (which is equivalent to £70.60 for each Council Tax Band D property).

9. Risk Assessment *(potential hazards or opportunities affecting corporate, service or project objectives*

9.1 In order to mitigate risk, the investment priorities are the security of the Council's capital and the liquidity of its investments. Within these priorities the aim is to achieve the optimum return on investments. Investment activities are carried out in accordance with the approved Annual Strategy and comply with the CIPFA Code of Practice. The treasury management function is supported by external advisors (Sector Treasury Services Limited) who provide on-going advice on investment strategies and policies together with daily updates on the credit rating of individual banks and building societies.

9.2 The Council has a high level of capital receipts and other balances. The interest obtained on the investment of these balances is significant and helps to support the annual level of Council Tax. Fluctuations in interest rates and levels of capital expenditure and receipts can impact considerably on the Council's budget. The Council has established an Interest Equalisation Reserve which can be used to help smooth out year-on-year variances in investment returns. In addition, the portfolio of investments includes loans for varying periods of duration of up to five years at fixed rates of interest and these give some certainty of return for a proportion of the investments.

Risk area	**Inherent level of Risk** (before controls)	**Controls**	**Residual Risk** (after controls)
	High/Medium/Low		High/Medium/Low
Economic (fluctuations in interest rates)	High	Spread of investments for periods of up to five years	High
Bank / building society failure resulting in loss of Council funds.	High	Use of Sector advice on credit ratings (based on Fitch, Moody and Standard and Poors ratings) and restrictions in use of non-rated building societies. Use of sovereign ratings to assess ability of Countries to support failing banks.	Medium
Fluctuations in capital expenditure and asset disposal programmes having significant impact on target investment returns.	Medium	Budget monitoring Interest Equalisation Reserve	Medium

10. Legal or policy implications

10.1 Consideration of the report complies with Council policy and the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice.

Wards affected	All	**Portfolio Holder**	Resources and Efficiency
Background Papers		**Subject Area** Finance	

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APPENDIX 1

Adoption of the revised CIPFA Treasury Management Code of Practice 2009

1. INTRODUCTION

1.1 The CIPFA Code of Practice on Treasury Management in Local Authorities was last updated in 2001 and has been revised in 2009 in the light of the default by Icelandic banks in 2008.

1.2 **Key Requirements of the Revised Code** - The revised Code has emphasised a number of key areas of treasury management 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 programme or to finance future debt maturities.
h) The main annual treasury management reports MUST 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).

1.3 The Council's Treasury Management and Investment Strategy Statements 2010/11 (Appendix 2) have been prepared in accordance with the revised Code.

2. The Council's Constitution: Revised Treasury Management Clauses

2.1 The revised Code requires that Full Council formally adopt the following four treasury management clauses for inclusion within the Council's Constitution:

"1. The Council will create and maintain, as the cornerstones for effective treasury management:

- *a treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities*
- *suitable treasury management practices (TMPs), setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.*

2. The Council will receive reports on its treasury management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its TMPs.

3. The Council delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to the Cabinet, and for the execution and administration of treasury management decisions to the Chief Finance Officer, who will act in accordance with the organisation's policy statement and TMPs and, if he/she is a CIPFA member, CIPFA's Standard of Professional Practice on Treasury Management.

4. This organisation nominates the Performance and Audit Scrutiny Committee (or sub committee thereof) to be responsible for ensuring effective scrutiny of the treasury management strategy and policies."

3. Revised Treasury Management Reporting Arrangements

3.1 The Code requires changes in treasury management reporting arrangements, including additional reporting requirements to Full Council, and enhanced scrutiny arrangements. The Council's Treasury Management and Investment Strategy will continue to be approved annually by the Full Council and there will also be a mid year report. In addition there will be monitoring reports and regular review by Councillors in both executive and scrutiny functions. 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.

3.2 The below table provides a summary of the current and new reporting arrangements as required by the revised Code: -

Current Reporting Arrangements	Future Reporting Arrangements (from 2010/11)
Cabinet / Council: • Revised Code and TM Policy (as required) • Annual Treasury Management and Investment Strategy (prior to start of financial year)	**Cabinet / Council:** • Adopting of revised Code and TM Policy (as required) • Annual Treasury Management and Investment Strategy (prior to start of financial year) • Mid year treasury management review (new report) • Annual outturn report
Cabinet only: • Quarterly treasury management performance reports • Annual outturn report (annually after year end)	**Cabinet only:**
Treasury Management Sub-Committee:	**Treasury Management Sub-Committee:** • Adoption of revised Code and TM Policy (as required) • Quarterly treasury management performance reports • Annual Treasury Management and Investment Strategy • Mid year treasury management review • Annual outturn report

3.3 Wherever possible individual reporting requirements to the above committees will be consolidated within the quarterly treasury management reports (eg this report combines the third quarter's treasury management performance report with the Annual Treasury Management and Investment Strategy report).

Annual Treasury Management and Investment Strategy Statements 2010/11

1. Introduction

Treasury Management Policy Statement

1.1 The Council defines its treasury management activities as: "The management of the authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".

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

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

Treasury Management Strategy for 2010/2011

1.4 The Local Government Act 2003 (the Act) and supporting regulations requires the Council to 'have regard to' the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

1.5 The Act therefore requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance issued subsequent to the Act); this sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

1.6 The suggested strategy for 2010/11 in respect of the following aspects of the treasury management function is based upon the Chief Finance Officer's views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor, Sector Treasury Services Limited (Sector). The strategy covers:

- Statutory requirement for a balanced budget
- treasury limits in force which will limit the treasury risk and activities of the Council
- prudential indicators
- the current treasury position
- prospects for interest rates
- the borrowing strategy
- the investment strategy
- creditworthiness policy and lending criteria
- policy on use of external providers

- the treasury management scheme of delegation
- the Council's Minimum Revenue Provision (MRP) strategy.

Balanced Budget Requirement

1.7 It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore, means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from:

- increases in interest charges caused by increased borrowing to finance additional capital expenditure, and
- any increases in running costs from new capital projects are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

2. Treasury Limits for 2010/11 to 2012/13

2.1 It is a statutory duty under S.3 of the Local Government Act 2003 and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the "Affordable Borrowing Limit". In England and Wales the Authorised Limit represents the legislative limit specified in section 3 of the Local Government Act 2003.

2.2 The Council must have regard to the Prudential Code when setting the Authorised 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 is 'acceptable'.

2.3 The Council is debt free and there are no plans to borrow monies in the foreseeable future. Within this overall strategy the Chief Finance Officer may approve short term borrowings (ie less than 12 months in duration) to provide for day to day cash flow management requirements. This does not affect the Council's debt free strategy or status.

3. Prudential and Treasury Indicators for 2010/11 – 2012/13

3.1 The Prudential Code requires the Council to set Prudential Indicators on External Debt. As indicated above it is not anticipated that the Council will undertake any borrowing with the result that the required indicators for "Authorised Limit", "Operational Boundary" and the "Maturity Structure of Borrowing" will all be zero.

3.2 The Council must also consider risk associated with interest rate exposures and set upper limits on the level of investments for both fixed rate and variable rate investments, together with an upper limit on the level of investments with maturity of more than 364 days. The majority of in-house investments are fixed rate. To provide maximum flexibility it is proposed that the upper limit on fixed rate investments be set at 95% of the amount available for investment. Similarly in order to provide maximum flexibility, the upper limit on variable rate investments has been set at 40% of total investments, so that at all times the Council has at least 55% in fixed rate investments to provide stability.

3.3 With regard to sums invested for more than 364 days, there is a need to balance certainty of income with flexibility to take advantage of upward movements in interest rates, whilst at the same time retaining a core element of investments that can be easily liquidated should the need arise. The upper limit on investments for more than 364 days has therefore been set at £20 million. This figure allows the in-house treasury management team to invest up to £20 million for periods of 1-5 years to provide increased certainty of income.

3.4 As a result the following prudential and treasury management indicators are relevant for the purposes of setting an integrated treasury management strategy.

	2008/09	2009/10	2010/11	2011/12	2012/13
TREASURY MANAGEMENT PRUDENTIAL INDICATORS	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
	actual	**probable outturn**	**estimate**	**estimate**	**estimate**
Authorised limit for external debt -					
Borrowing	£0.00	£0.00	£0.00	£0.00	£0.00
other long term liabilities	£0.00	£0.00	£0.00	£0.00	£0.00
TOTAL	£0.00	£0.00	£0.00	£0.00	£0.00
Operational boundary for external debt -					
Borrowing	£0.00	£0.00	£0.00	£0.00	£0.00
other long term liabilities	£0.00	£0.00	£0.00	£0.00	£0.00
TOTAL	£0.00	£0.00	£0.00	£0.00	£0.00
Upper limit for fixed interest rate exposure					
expressed as a % of total investments			95%	95%	95%
Upper limit for variable rate exposure					
expressed as a % of total investments			40%	40%	40%
Upper limit for total principal sums invested for over 364 days (per maturity date)			£20m	£20m	£20m

3.5 The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. The Code was adopted by the Full Council on 21 March 2002 and the revised Code will be adopted on 23 February 2010.

4. Current Portfolio Position

4.1 The Council's treasury portfolio position at 31 December 2009 was:

Investments	Amount
Total Investments (in-house)	£45.2m
Average rate of return (April to December 2009)	2.43%
Debt	£nil

5. Prospects for Interest Rates

5.1 The Council has appointed Sector Treasury Services as treasury advisors to the Council and part of their service is to assist the Council to formulate a view on interest rates. Appendix 3 draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. The following table gives the Sector central view.

Sector Bank Rate forecast for the financial year ends (March)

- **2010 0.50%**
- **2011 1.50%**
- **2012 3.50%**
- **2013 4.50%**

5.2 There is downside risk to these forecasts if recovery from the recession proves weaker and slower than currently expected. Sector's detailed view of the current economic background to these forecasts is provided at Appendix 3.

6. Borrowing Strategy

6.1 It is anticipated that there will be no capital borrowings required during 2010/11.

7. Annual Investment Strategy

Investment Policy

7.1 The Council will have regard to the Department for Communities and Local Government's (CLG) Guidance on Local Government Investments ("the Guidance") issued in March 2004, any revisions to that guidance, the Audit Commission's report on Icelandic investments and the 2009 revised CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code").

7.2 The Council's investment priorities are the security of capital and the liquidity of its investments. The Council will also aim to achieve the optimum return on investments commensurate with proper levels of security and liquidity.

7.3 The borrowing of monies purely to invest or on-lend and make a return is unlawful and the Council will not engage in such activity.

7.4 Investment instruments identified for use in the financial year are at 8.7 and 8.8 below.

8. Creditworthiness Policy and Lending Criteria

8.1 This Council uses the creditworthiness service provided by Sector Treasury Services. This service has been progressively enhanced over the last year 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
- credit default spread to give early warning of likely changes in credit ratings
- sovereign ratings to select counterparties from only the most creditworthy countries

8.2 This modelling approach combines credit ratings, credit watches, credit outlooks and credit default swaps in a weighted scoring system for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Council to determine the duration for investments and are therefore referred to as durational bands. The Council is satisfied that this service now gives a much 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.

8.3 The selection of counterparties with a high level of creditworthiness will be achieved by selection of institutions down to a minimum durational band within Sector's weekly credit list of worldwide potential counterparties. The Council will therefore use counterparties within the following colour / maximum investment durational bands:-

- Purple 2 years
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 3 months
- No Colour not to be used

8.4 All credit ratings will be monitored on an on-going 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 Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

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

8.6 **Country limits -** The Council has determined that it will only use approved counterparties from countries other than the UK with a minimum sovereign credit rating of AAA from Fitch Ratings (or equivalent from other agencies if Fitch does not provide).

8.7 **Specified Investments -** All such investments will be sterling denominated, with maturities up to maximum of 1 year, meeting the minimum 'high' rating criteria where applicable.

	Minimum 'High' Credit Criteria
Debt Management Agency Deposit Facility	--
Treasury Bills	--
Term deposits – local authorities	--
Term deposits – banks and building societies (see separate table for credit criteria re non-rated building societies)	Short-term F1, Long-term A, Individual C, Support 3
Bonds issued by a financial institution which is guaranteed by the UK government	AAA
Certificates of deposits issued by banks and building societies	Short-term F1, Long-term A, Individual C, Support 2
Sovereign bond issues (non-UK)	AAA
Money Market Funds	Short-term F1, Long-term A, Individual C, Support 2

8.8 **Non-Specified Investments -** All such investments will be sterling denominated, with maturities over 1 year, meeting the minimum 'high' rating criteria where applicable, or with non rated organisations – ie non rated building societies.

A maximum of 90% will be held in aggregate in non-specified investments

	Minimum Credit Criteria	**Max % of total investments**	**Max. maturity period**
Term deposits – other LAs with maturities >1yr	-	50	2 years
Term deposits – banks and building societies (see separate table for credit criteria re build socs) with maturities >1yr	Short-term F1+ Long-term AA- Individual B/C Support 2	90	2 years
Bonds issued by multilateral development banks with maturities >1yr	AAA	25	2 years
Bonds issued by a financial institution which is guaranteed by the UK government with maturities >1yr	AAA	25	2 years

8.9 **Lending Criteria – 2010/11 -** The Council's lending criteria has been developed in consultation with Sector and is based on their colour coded creditworthiness assessment (ie colour code system) which takes into account the above minimum credit criteria.

Lending Criteria: Rated Banks and Institutions

Sector Colour Code Key*	Maximum value / duration
Purple	Max 20% portfolio (approx £9m) for max 2 years
Blue	£9m for max 1 year
Orange	£6m for max 1 year
Red	£5m for max 6 months
Green	£3m for max 3 months

8.10 The lending criteria for rated building societies is based on the same Sector colour coding system as the rated banks. However, in recognition of their mutual status and the increased regulatory framework governing such societies, the Council's strategy allows for longer investment durations than comparable banks.

Lending Criteria – Rated Building Societies

Sector Colour Code Key	Maximum value / duration
Red	£5m for max 1 year
Green	£3m for max 1 year

Note – No UK building society is currently rated above Green

8.11 The majority of UK building societies do not obtain formal credit ratings and as such, investments with these organisation have to be treated with caution. In the absence of formal credit ratings the following credit criteria (based on asset values and other sources of financial and credit rating information) have been established by the Council in consultation with Sector.

Non Rated Building Societies – Asset Base Criteria

	Maximum value / duration
Building Societies – Asset base > £1,000m	£2.5m for max 6 months
Building Societies – Asset base > £2,500m	£3m for max 6 months

8.12 In addition to the above asset base criteria the following additional criteria are applied:

- Only building societies specifically covered by the provisions of the government's banking support package are to be used
- A commercial credit rating organisation, Dun and Bradstreet, to be used to provide credit rating reports on building societies, prior to the placing of funds, to ensure that the proposed investment values are within recommended credit limits
- Latest available accounts to be obtained and reviewed by in-house staff to establish key trends and to ensure that Dun and Bradstreet recommendations are based on latest available financial results
- Review of available media coverage for any advance negative warnings regarding the stability of individual building societies.

8.13 The Chief Finance Officer, in consultation with the Portfolio Holder Resources and Efficiency, will continue to monitor the adequacy of the above lending criteria and make changes as necessary to respond to the changing economic climate and external advice. Details of any changes made will be included within the next treasury management reporting cycle to the Performance and Audit Scrutiny Treasury Management Sub Committee, Cabinet and Full Council.

9. Investment Strategy

9.1 **Management of Council's Investments -** All the Council's investments are currently managed in house**.** The majority of the Council's investments are placed through the money markets with banks and building societies for fixed periods of time (up to five years duration) and at fixed rates of interest. The Council also retains a core balance within liquidity accounts which takes account of the Council's proposed capital expenditure and the need to retain flexibility for cash flow purposes. The minimum amount which is to be held during the financial year in investments other than long term investments should be £20 million. Investments will accordingly be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

9.2 So far as fixed term investments are concerned, as at the time of this report, the Council already has a number of investments that span the financial year including longer dated deposits and callable deposits. This includes a callable deposit of £5m which could run to March 2011.

9.3 **Bank Base Rate Projections** - The Bank Rate has been unchanged at 0.50% since March 2009. Sector forecast that rates will commence rising in quarter three of 2010/11 and then to rise steadily thereafter. Their Bank Rate forecasts for financial year ends (March) are as follows: -

- **2010** 0.50%
- **2011** 1.50%
- **2012** 3.50%
- **2013** 4.50%

9.4 Sector advise that there is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected.

9.5 The Council will avoid locking into longer term deals while investment rates are down at historically low levels unless exceptionally attractive rates are available which make longer term deals worthwhile.

9.6 **2010/11 Target Rate on Investments** - Sector is advising clients for 2010/11 to budget for an average investment return of 0.9% on investments placed during 2010/11. Based on this projection, and taking into account the returns being achieved on the Council's current portfolio of fixed term investments, the average target rate investment return for 2010/11 is 1.5%. For 2011/12 Sector project an average investment rate of 2.9% rising to 4.2% during 2012/13. These rates are used to help inform the Council's fixed term investment decisions.

9.7 For its cash flow generated balances, the Council will seek to utilise its business reserve accounts and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

9.8 Taking into account the projected value of the investment portfolio after cash flow movements during 2010/11, it is estimated that investments in 2010/11 will generate income of £566,000. This is equivalent to £14.91 for each Council Tax Band D property.

9.9 **End of Year Investment Report** - At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

10. Property Portfolio

10.1 The Council also owns a non-operational property portfolio which is managed on robust estate management and asset management principles. Its capital value, as in the balance sheet at 31 March 2009 was £25,160,000. It is estimated that in 2010/11 this will generate income of £2,680,000; equivalent to £70.60 for each Council Tax Band D property.

11. Policy on the use of external service providers

11.1 The Council uses Sector Treasury Services (Sector) as its external treasury management advisors. 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.

12. Treasury management scheme of delegation

12.1 The Council's scheme of delegation for the treasury management function is as follows:

(i) Cabinet / Full Council

- Adoption of revised CIPFA Treasury Management Code and Treasury Management Policy
- Approval of Annual Treasury Management and Investment Strategy (prior to start of financial year)
- Receiving / reviewing mid-year treasury management report
- Receiving / reviewing annual outturn report

- Budget consideration and approval

(ii) Performance and Audit Scrutiny Committee (Treasury Management Sub Committee)

- reviewing the treasury management policy and procedures and making recommendations to the Cabinet / Full Council
- reviewing quarterly treasury management performance reports, mid year review and annual outturn reports and making recommendations to Cabinet / Full Council

(iii) The treasury management role of the Chief Finance Officer

- recommending clauses and treasury management policy for approval, reviewing the same regularly, and monitoring compliance
- approval of treasury management practices (TMPs)
- submitting regular treasury management policy reports
- submitting budgets and budget variations
- receiving and reviewing management information reports
- reviewing the performance of the treasury management function
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function
- ensuring adequacy of division of duties
- ensuring the adequacy of internal audit, and liaising with external audit
- approving the appointment of external service providers

13 Minimum Revenue Provision Policy Statement

13.1 Capital expenditure is generally expenditure on assets which have a life expectancy of more than one year e.g. buildings, vehicles, machinery etc. Capital expenditure can be financed though the Council's capital reserves (accumulated from capital receipts), revenue contributions (including use of revenue reserves) or external debt. Where capital expenditure is financed by external debt it would be impractical to charge the entirety of such expenditure to revenue in the year in which it was incurred and such expenditure is spread over several years to match the expected useful life of the asset. The manner of spreading these costs is through an annual Minimum Revenue Provision, which was previously determined under Regulation, and will in future be determined under Guidance.

13.2 Statutory Instrument 2008 no. 414 s4 lays down that:

"A local authority shall determine for the current financial year an amount of minimum revenue provision that it considers to be prudent."

The above is a substitution for the previous requirement to comply with regulation 28 in S.I. 2003 no. 3146, (as amended)

13.3 There is no requirement to charge MRP where the Council's Capital Financing Requirement (the underlying need for the Council to borrow) is nil or negative at the end of the preceding financial year. As the Council is currently debt free there is therefore no requirement to charge MRP. Should the Council's debt free status change the Council will implement the Minimum Revenue Provision (MRP) in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

Economic Background – National and International Forecasts

1. Introduction

1.1 This appendix provides a summary of the international and national economic forecasts (including details of comparative interest rates projections) provided by the Council's treasury management advisors, Sector Treasury Services Ltd (Sector). This information is provided in support of Sector's projections on interest rates which are used by the Council to determine the annual target rate of investment return which is used to estimate investment returns in 2010/11 and future years.

2. Sector's National and International Forecasts

- The credit crunch storm of August 2007 eventually fed through to the near collapse of the world banking system in September 2008. This then pushed most of the major economies of the world into a very sharp recession in 2009 accompanied by a dearth of lending from banks anxious to rebuild their weakened balance sheets. Many governments were forced to recapitalise and rescue their major banks and central banks precipitately cut their central bank rates to 0.10 – 1.00% in order to counter the recession.
- The long awaited start of growth eventually came in quarter 3 2009 in the US and the EU. However, there was disappointment that the UK failed to emerge from recession in quarter 3.
- Inflation has plunged in most major economies and is currently not seen as being a problem for at least the next two years due to the large output gaps and high unemployment putting a lid on wage growth. In many countries there have been widespread pay freezes in 2009 and these are likely to be persistent for some time.
- Deflation could become a threat in some economies if they were to go into a significant double dip recession.
- Asian countries, especially China, are buoying world demand through their own stimulus measures.
- There still needs to be a radical world rebalancing of excess savings rates by cash rich Asian and oil based economies and excess consumption rates in Western economies if the world financial system is not to avoid a potential rerun of this major financial crisis in years to come.
- Most major economies have resorted to a huge expansion of fiscal stimulus packages in order to encourage a fast exit from recession. This, together with expenditure on direct support provided to ailing banks, has led to a drastic expansion in government debt levels which will take many years to eliminate and to restore the previous health of national finances.

3. Two growth scenarios

- The current big issue is 'how quickly will the major world economies recover?' There is a sharp division of opinion on this question as set out below. This has a knock-on effect on forecasts for interest rates.

4. Strong recovery

- This is a normal cyclical recovery which will be strong in the major world economies. The US still has potential to add further fiscal stimulus in 2010 to ensure that strong recovery continues after the current round of stimulus measures end. Growth in the EU is likely to be strong in 2010 and not require such help.

5. The UK:

- GDP growth will almost get back to the long term average of about 2.5% in 2011 but is likely to peak in the first half of the year as inventory rebuilding and stimulus measures fade and fiscal contraction kicks in later in the year.
- The economy will rebalance with strong growth in exports and import substitution helped by strong recovery in the EU and the rest of the world.
- Sterling has depreciated by 25% since the peak in 2007 and is likely to stay weak.
- Consumer spending – only a mediocre recovery is expected due to a steady increase in the savings ratio from 5.6% in 2009 to about 8% in 2011 as consumers pay down debt or build cash balances. Consumer incomes will be held down by wage freezes and increases in taxation.
- House price recovery is expected to persist helped by a low Bank Rate for a prolonged period; the peak to trough fall in house prices is now expected to be no more than 20%. House prices to rise by about 6% in 2010, and 3% in 2011; mortgage approvals will rise back to the level of 75 - 80,000 per month needed to ensure a continuation of a trend of rising house prices.
- CPI inflation to peak @ 2.5% in early 2010 after the rise in VAT in January but then to fall to a trough near 1.5% in early 2011 and to stay below 2% for the rest of 2011.
- The current Monetary Policy Committee (MPC) attitude is one of hang on as long as possible before increasing Bank Rate. The aim of this would be to try to ensure that growth gets going at a decent rate and that Bank Rate gets back to 4 – 5% before the next recession and that all assets purchased through quantative easing (QE) have been sold off by then. The first Bank Rate increase is expected in Q3 2010.
- If there is a change of Government in 2010 with a more aggressive fiscal approach then this could delay the timing of Bank Rate starting to go up.
- The fiscal deficit is 6.4% of GDP, about £90bn, which is expected to fall at £11bn p.a. over eight years at currently planned rates. This is similar to the peak deficit of 7% in 1990s which was remedied to a surplus of 1.6% in the space of 6 years helped by strong, steady economic growth of 3% p.a. supported by loose monetary policy that compensated for the fiscal squeeze.
- Gilt yields, especially longer term ones, are currently artificially low due to the Bank of England's Quantitative Easing operations. £200bn of gilts, commercial bonds and paper are being purchased under this scheme which has inflated prices and depressed yields. Once this campaign ends, yields will inevitably rise but will also rise due to the huge level of issuance of new gilts to finance the fiscal deficit. Long gilt yields are therefore forecast to reach 6% during 2011.
- Gilt yields could rise higher if there was a hung Parliament in 2010 or if the fiscal situation deteriorates further.
- The major risk to this scenario would be a lack of supply of bank credit. However, it is felt that the Bank of England is on alert to ensure that this does not happen and would continue various measures to assist the expansion of credit.

6. Weak recovery

- The current economic cycle is not a normal business cycle but a balance sheet driven cycle. Over borrowed banks, corporates and consumers are focused on shrinking their levels of borrowing to more viable and affordable levels and this balance sheet adjustment will take several years to be effected. Repayment of debt will therefore act as a major head wind to the required increase in demand in the economy. Consequently there will only be weak economic recovery over the next few years after the initial sharp inventory rebuilding rebound fades. GDP growth is forecast to reach only +1.5% in 2011.

- Fiscal contraction will further dampen economic recovery driven by a strong political agenda to accelerate cuts in expenditure and increases in taxation after the general election in 2010.
- The consumer savings ratio will rise so as to eliminate over borrowing and to insure against people losing their jobs during this downturn. This will depress consumer expenditure, the main driver of the UK economy.
- Growth will also be hampered by a reduced supply of credit from weakened banks compounded by weak demand for credit.
- The eventual reversal of Quantitative Easing will take cash out of the economy and reduce demand in the economy.
- Unemployment is likely to rise to near to 3m in 2010 and take years to subside due to weak growth. High unemployment will reduce tax income and increase expenditure on benefits and the costs of local authority services.
- Inflation will not be a threat for several years as the current 6% output gap will take until 2014 to be eliminated.
- However, deflation is a major danger for some years: the major falls in manufacturing prices over the last 12 -18 months have still to feed through to the economy and then to impact wage deflation.
- CPI inflation will blip up over 2% in early 2010 but will then be on a strong downward trend to about -1% in 2011.
- There is no need for the MPC to change Bank Rate from 0.5% in 2010 or 2011 and possibly for 5 years as they will need to counter the fiscal contraction which will dampen demand in the economy.
- Long PWLB rates will <u>FALL</u> from current levels to near 4% in 2010 due to weak economic recovery and minimal inflation so that the real rate of return (net of inflation) on long gilts is healthy at these low levels.

7. Sector view

- Sector recognises that at the current time it is difficult to have confidence as to exactly how strong the UK economic recovery will prove to be. Both the above scenarios are founded on major assumptions and research which could or could not turn out to be correct.
- Sector has adopted a more moderate view between these two scenarios outlined above i.e. a moderate return to growth.
- We do, however, feel that the risks that long term gilt yields and PWLB rates will rise markedly are high.
- There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas: -
  - degree of speed and severity of fiscal contraction after the general election
  - timing and amounts of the reversal of Quantitative Easing,
  - speed of recovery of banks' profitability and balance sheet imbalances
  - changes in the consumer savings ratio
  - rebalancing of the UK economy towards exporting and substituting imports
- The overall balance of risks is weighted to the downside i.e. the pace of economic growth disappoints and Bank Rate increases are delayed and / or lower
- There is an identifiable risk of a double dip recession and deleveraging creating a downward spiral of falling demand, falling jobs and falling prices and wages leading to deflation but this is considered to be a small risk and an extreme view at the current time on the basis of current evidence

3. Interest Rate Forecasts

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.

1. INDIVIDUAL FORECASTS

Sector interest rate forecast – 23.11.09

	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Bank rate	0.50%	0.50%	0.75%	1.00%	1.50%	2.25%	2.75%	3.25%	3.50%	3.75%	4.25%	4.25%	4.50%
5yr PWLB rate	3.05%	3.20%	3.30%	3.40%	3.60%	3.85%	4.15%	4.55%	4.60%	4.80%	4.80%	4.85%	4.85%
10yr PWLB rate	4.00%	4.05%	4.15%	4.30%	4.45%	4.60%	4.80%	4.90%	5.00%	5.10%	5.10%	5.15%	5.15%
25yr PWLB rate	4.55%	4.65%	4.70%	4.80%	4.90%	5.00%	5.05%	5.10%	5.20%	5.30%	5.30%	5.35%	5.35%
50yr PWLB rate	4.60%	4.70%	4.75%	4.90%	5.00%	5.10%	5.15%	5.20%	5.30%	5.40%	5.40%	5.45%	5.45%

Capital Economics interest rate forecast – 18.1.10

	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%
5yr PWLB rate	3.15%	2.95%	2.65%	2.45%	2.45%	2.45%	2.45%	2.45%
10yr PWLB rate	4.45%	4.15%	3.65%	3.15%	3.15%	3.15%	3.15%	3.15%
25yr PWLB rate	4.75%	4.65%	4.35%	4.05%	3.95%	3.75%	3.75%	3.75%
50yr PWLB rate	4.65%	4.65%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%

UBS interest rate forecast (for quarter ends) – 30.10.09

	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Bank Rate	0.50%	0.50%	0.75%	1.00%	1.50%	2.00%	2.50%	3.00%
10yr PWLB rate	3.90%	4.05%	4.40%	4.75%	4.90%	5.15%	5.40%	5.40%
25yr PWLB rate	4.45%	4.65%	5.00%	5.15%	5.40%	5.65%	5.90%	5.90%
50yr PWLB rate	4.55%	4.75%	5.10%	5.25%	5.50%	5.75%	6.00%	6.00%

2. SURVEY OF ECONOMIC FORECASTS

HM Treasury December 2009 – summary of forecasts of 23 City and 12 academic analysts for Q4 2009 and 2010. Forecasts for 2010 – 2013 are based on 21 forecasts in the last quarterly forecast – November 2009.

BANK RATE FORECASTS		quarter ended		annual average Bank Rate			
	actual	Q4 2009	Q4 2010	ave. 2010	ave. 2011	ave. 2012	ave. 2013
Median	0.50%	0.50%	1.30%	0.70%	1.80%	3.00%	3.70%
Highest	0.50%	0.50%	2.30%	1.30%	3.30%	4.30%	4.60%
Lowest	0.50%	0.50%	0.50%	0.50%	0.50%	1.00%	1.40%