APPENDIX D

Treasury Management Strategy 2010/11 to 2012/13

For approval by Council 03 March 2010

Introduction

1. The treasury management function is an important part of the overall financial management of the Council's affairs. Its importance has increased as a result of the freedoms provided by the Prudential Code. Whilst the prudential indicators consider the affordability and impact of capital expenditure decisions, the treasury function covers the effective funding of these decisions. There are also specific treasury indicators included in this strategy that need approval.
2. The Council's activities are strictly regulated by statutory requirements and a professional code of practice (i.e. the CIPFA Code of Practice on Treasury Management, revised November 2009: the "Code"). This Council originally adopted the Code on 13 February 2002, and will now adopt the revised Code. In doing so, it will also adopt an updated treasury management policy statement.
3. The Code requires an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming 3 years. A further report is produced after the year-end to report on actual activity for the year. As a consequence of the revised Code, a mid year monitoring report will now also be produced for Council.
4. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury function.
5. This strategy therefore covers:
   - the current treasury position;
   - expected movement in interest rates;
   - the Council's borrowing and debt strategy (including its policy on making provision for the repayment of debt);
   - the Council's Investment Strategy;
   - specific limits on treasury activities;
   - treasury management indicators; and
   - specific sections on training and the use of consultants.

   This strategy document contains the relevant information to comply with both the Code and the draft updated Investment Guidance issued by Government. The sections that specifically satisfy requirements of the Investment Guidance are: specified and non specified investments (33-42), credit risk assessment (34-39), use of investment consultants (52-53), training (54), borrowing in advance of need (10) and length of deposits (40-44).

Treasury Position

6. The forecast treasury position and the expected movement in debt and investment levels over the next three years are as follows.

Table 1: Gross external debt and investment forecast

	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
	£'000	**£'000**	**£'000**
EXTERNAL DEBT			
Borrowing	**39,200**	**39,200**	**39,200**
Other long term liabilities	**260**	**255**	**250**
Total Debt at 31 March	**39,460**	**39,455**	**39,450**
INVESTMENTS			
Total Investments at 31 March	**8,800**	**8,800**	**8,800**
Total investment adjusted for Iceland 31 March*	**3,640**	**4,810**	**5,730**
Projected average investment balances*	**9,635**	**10,455**	**11,305**

*cash balances projected assuming non priority creditor status for Glitnir

7. The forecast position on external borrowing remains static across the three years, despite the fact that by the end of 2009/10 the Council's Capital Financing Requirement (CFR: i.e. the underlying need to borrow) is projected to be well in excess of net long term borrowings (see Prudential Indicator PI13) although debt boundaries (see Prudential Indicators PI 9 and 10) have been set above this level to allow for additional borrowing should it be required, for example, if assumptions about capital receipts are not realised. The twin issues of the amounts set aside for the future repayment of debt, and a cashflow position which is forecast to remain relatively stable, mean that there is no immediate need to take out new loans.

8. The revenue consequences of these balances, namely investment income and borrowing costs (and the relevant recharges between the HRA), are included within the overall revenue budget.

9. The projected average investment balances indicate the difference between the gross and the net borrowing position. This is projected to be lower than in prior years due to the repayment of PWLB loans in January 2009 (£5.6M) and the potential loss of principal from Icelandic banks.

10. Although the Council holds both investment balances and long terms borrowings, this is not a result of borrowing in advance of need or to on-lend. The Council's external borrowings provide the cash to help pay for a proportion of the Council's ongoing and accumulated capital spend (the CFR). Separate to this the Council is required to hold a certain amount of balances, provisions and other items to ensure that resources are available when needed; these are generally cash backed. Flexibility is allowed on utilising these cash funds in lieu of borrowing, which the Council is doing in part.

Scenario Review

11. The position above assumes that there will be no pressure to physically borrow to support the capital programme over the next three years, although it does assume that cash balances will be reduced due to Icelandic impairments (including having no priority creditor status for Glitnir) and the proposed Lancaster Market scheme. This is equivalent to scenario 2 below. However, there are two large elements that could lead to a change in this position. These are the potential impact of Luneside East compensation claims and the potential failure to achieve capital receipts for sale of land at South Lancaster. The potential incremental effect of these over the period 2009/10 to 2012/13 on the Council's borrowing requirement and its need to make provision for repayment in its revenue budget (MRP: Minimum Revenue Provision) can be seen overleaf:

Table 2. Debt scenarios for the period to 2012/13

	Borrowing requirement over Period £'000	Total MRP over a four year period £'000	Movement in CFR over period £'000
Scenario 1, "Best case", capitalisation not needed for Icelandic Impairment	-900	5,462	-6,362
Scenario 2, Capitalisation of Icelandic impairment in 2009/10 (i.e. reflects proposed Programme)	1,147	5,708	-4,561
Scenario 3, Icelandic impairment and illustrative Luneside East costs	5,647	6,068	-421
Scenario 4, "Worst case", Icelandic impairment, Luneside East and South Lancaster land not sold	13,147	6,368	6,779

12. From the table above is it clear that the effect of Luneside East and capital receipts from sale of land at South Lancaster could have a large impact on the Council's CFR and its potential debt position, as well as the annual revenue provision that will have to be set aside, irrespective of whether physical borrowing is taken out or not.

13. It is important to note that any increase in CFR does not necessarily lead to an increase in physical borrowing. Should physical borrowings not be required, this would be due to internal cash being applied instead, as outlined in paragraph 10. In the current climate, where investment returns are well below the cost of borrowing, this would be the preferred option. Where there is an increase in CFR however, there would be either be a real interest charge arising should new borrowing be taken out, or a loss of investment income should existing cash balances be used to support the capital expenditure.

Expected Movement in Interest Rates

Table 3: Medium-Term Rate Estimates (averages)

Annual Average %	Bank Rate	Money Rates		PWLB Rates*		
		3 month	1 year	5 year	20 year	50 year
2008/09	3.9	5.0	5.3	4.2	4.8	4.5
2009/10	0.5	0.8	1.4	3.2	4.4	4.6
2010/11	1.0	1.5	2.3	4.0	5.0	5.2
2011/12	2.0	2.5	3.3	4.3	5.3	5.3
2012/13	4.5	4.8	5.3	5.3	5.5	5.3

* Borrowing Rates

Information provided by Butlers Consultants January 2010:

14. Short-term rates are expected to remain on hold for a considerable time. The recovery in the economy has commenced but it will remain insipid and there is a danger that early reversal of monetary ease, (rate cuts and Quantative Easing (QE)), could trigger a dip back to negative growth and a W-shaped Gross Domestic Product (GDP) path.

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

16. The main drag upon the economy is expected to be weak consumers' expenditure growth. The combination of the desire to reduce the level of personal debt and job uncertainty is likely to weigh heavily upon spending. This will be amplified by the prospective increases

in taxation already scheduled for 2010 – VAT and National Insurance. Without a rebound in this key element of UK GDP growth, any recovery in the economy is set to be weak and protracted.

17. The Monetary Policy Committee (MPC) will continue to promote easy credit conditions via quantitative monetary measures. QE has been extended to a total of £200BN. Whether this has much impact in the near term remains a moot point given the personal sector's reluctance to take on more debt and add to its already unhealthy balance sheet.

18. With inflation set to remain subdued in the next few years (though a sharp blip is forecast for the next few months), the pressure upon the MPC to hike rates will remain moderate. But some increase will be seen as necessary in 2010 to counter the effects of external cost pressures (as commodity price strength filters through) and to avoid damage that sterling could endure if the UK is seen to defy an international move to commence policy exit strategies.

19. The outlook for long-term fixed interest rates is a lot less favourable. Whilst the UK's fiscal burden should ease in the future, this will be a lengthy process and deficits over the next two to three financial years will require a very heavy programme of gilt issuance. The market will no longer be able to rely upon Quantitative Easing to alleviate this enormous burden.

20. The programme was not extended in February. With growth back on the agenda and inflation challenging the upper limit of the Government's target range, going forward, the majority of MPC members may feel enough assistance has been given to ensure lack of credit is no longer a fundamental threat to the welfare of the economy.

21. The absence of the Bank of England as the largest buyer of gilts will shift the balance between supply and demand in the gilt-edged market. Other investors will almost certainly require some incentive to continue buying government paper.

22. This incentive will take the form of higher interest rates. The longer fixed interest rates will suffer from the lack of support from the major savings institutions – pension funds and insurance companies - who will continue to favour other investment instruments as a source of value and performance. The shorter fixed interest rates will be pressured higher by the impact of rising money market rates. While bank purchases in this part of the market will continue to feature as these institutions meet regulatory obligations, this process will be insufficiently strong to resist the upward trend in yields.

Borrowing and Debt Strategy 2010/11 to 2012/13

23. The uncertainty over future interest rates increases the risks associated with treasury activity. As a result the Council will take a cautious approach to its treasury strategy. As outlined in the scenarios section above, there are also a number of other factors outside of the Council's direct control, which could have a significant impact on its need to borrow. As these issues are clarified, the options around borrowing will be considered in relation to the longer term prospects of rate rises.

24. Long-term fixed interest rates are at risk of being higher over the medium term, and short term rates are expected to rise, although more modestly. The Head of Financial Services, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, if need be, taking into account the risks shown in the forecast above. It is likely that shorter term fixed rates may provide lower cost opportunities in the short to medium term.

25. With the likelihood of long term rates increasing, debt restructuring is likely to focus on switching from longer term fixed rates to cheaper shorter term debt, although the Head of Financial Services and treasury consultants will monitor prevailing rates for any opportunities during the year.

26. The option of postponing borrowing and running down investment balances will also be considered, this would have the added benefit of further reducing counterparty risk.

Provision for the Repayment of Debt 2010/11 to 2012/13

27. Up until 2007/08 the Council calculated the basic amount of provision, which it sets aside each year from revenue for the repayment of debt, in accordance with a prescribed formula based on the CFR. To this was added a further provision in respect of the financing of assets with relatively short lives, as considered prudent.

28. The new arrangements were introduced from 1 April 2008. In summary:

    - the prescribed formula has been abolished and replaced by a simple requirement for Councils to make 'prudent' provision;
    - the old calculation may still be used for relevant capital expenditure before 31 March 2008, but
    - provision relating to relevant capital expenditure after this date must either be based on the estimated life of the asset, or equal to the depreciation on the asset.

29. The new arrangements also included reference to 'supported' or unsupported' capital expenditure:

    - 'Supported' is the amount of capital expenditure for which the authority has received revenue support from Government to help meet the financing costs. (i.e. for credit / borrowing – it excludes grant financing).
    - 'Unsupported' is where the authority receives no such revenue assistance (often also referred to as prudential borrowing).

30. Financially, the new arrangements for calculating the Minimum Revenue Provision (MRP) has no real impact on the Council because the changes effectively codify the full 'prudent' provision which the Council was already making. Nonetheless, as an element of discretion has been introduced the Council's approach must be formalised within the borrowing strategy.

31. Therefore, for 2010/11, the Council's policy for the making of provision for the repayment of debt will be as follows:

    - For all relevant capital expenditure prior to 1 April 2008, with the exception of that in respect of motor vehicles (i.e. less than 15 years life), by the application of the former prescribed formula *(i.e. for General Fund, 4% of the non-housing related Capital Financing Requirement at the start of the year)*.
    - For capital expenditure on motor vehicles prior to 01 April 2008, and for all supported or unsupported capital expenditure on or after that date, equal annual amounts based on the estimated life of each individual asset so financed, as is consistent with the revised Minimum Revenue Provision guidance (February 2008, method 3).

Investment Strategy 2010/11 to 2012/13

32. The primary objective of the Council's investment strategy is to safeguard the re-payment of the principal and interest of its investments, with ensuring adequate liquidity being the second objective, and achieving investment returns being the third.

33. The types of investment allowable are categorised as either Specified and Non Specified investments. Details of these are set out in ***Appendix D1***.

34. Following the economic background described above, the current investment climate has one over-riding risk consideration, that of counterparty security risk. As a result of these underlying concerns, Officers are currently implementing an operational investment strategy which tightens the controls already in place. The Head of Financial Services will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. The use of these criteria

provides an overall pool of counterparties that are considered as high quality and that may be chosen for investment, subject to other considerations.

35. The rating criteria use the lowest common denominator method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance, if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside of the lending criteria. This complies with a CIPFA Treasury Management Panel recommendation in March 2009 and the actual Code.

36. Credit rating information is supplied by the Council's treasury consultants (Butlers) on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. More information on credit ratings is included in ***Appendix D2***.

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

- **Banks 1 - Good Credit Quality**

  The Council will only use banks that:

  a) are UK banks; or
  b) are non-UK but are domiciled in an EU country with a long term sovereignty rating of AAA,

  and have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated, as is consistent with the middle limit as per table 4):

  i. **Short Term:** F1/P-1/A-1

  ii. **Long Term:** A/A2/A

  iii. **Individual / Financial Strength:** C (Fitch / Moody's only)

  iv. **Support:** 3 (Fitch only)

- **Banks 2 – Guaranteed Banks with suitable Sovereign Support**

  In addition, the Council will use EU banks whose ratings fall below the criteria specified above if all of the following conditions are met:

  a) wholesale deposits in the bank are covered by a government guarantee;

  b) the government providing the guarantee is rated "AAA" by all three major rating agencies (Fitch, Moody's and Standard & Poors); and

  c) the Council's investments with the bank are limited to amounts and maturities within the terms of the stipulated guarantee.

- **Banks 3 – Eligible Institutions**

  The organisation is an Eligible Institution for the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008, with the necessary short and long term ratings required in *Banks 1* above. These institutions have been subject to suitability checks before inclusion, and have access to HM Treasury liquidity if needed.

- **Banks 4 – The Council's own Banker**

  The bank may be used for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

- **Building Societies –** all Societies that meet the ratings for banks outlined above.

- **Money Market Funds –** AAA-rated sterling funds with constant unit value.
- **UK Government –** Debt Management Account Deposit Facility (DMADF)
- **Local Authorities (including Police and Fire Authorities), Parish Councils**
- **Supranational institutions** (e.g. European Central Bank)

38. Due care will be taken to consider the country, group and sector exposure of the Council's investments. In part the country selection will be chosen by the credit rating of the Sovereign state in *Banks 1* above. In addition:

    - no more than 25% will be placed with any one non-UK country at any time;
    - limits in place above will apply to Group companies;
    - Sector limits will be monitored.

39. The updated Code of Practice and draft Investment Guidance now require the Council to supplement credit rating information. Whilst the Council's strategy relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (e.g. credit default swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

40. For the above categories of Specified and Non Specified Investments, and in accordance with the Code, the Council has developed additional criteria to set the maximum amounts that may be invested in these bodies. The criteria, using the lowest common denominator approach are set out below.

Table 4: Counterparty Criteria and Investment Limits

	Minimum across all three ratings				
	Fitch	Moody's	Standard & Poors	Money Limit[7]	Time Limiit[8]
Upper Limit[1]	F1+/AA-	P-1/AA3	A-1+/AA-	£4M	Instant access only
				£2M	3 months
Middle Limit[2]	F1/A	P-1/A2	A-1/A	£2M	Instant access only
Other Institutions[3]	N/A	N/A	N/A	£4M	1 Year
Money Market Funds[4]	AAA	AAA	AAA	£4M	Instant Access Only
DMADF deposit[5]	N/A	N/A	N/A	£20M	1 Year
Sovereign rating to apply to all non UK counterparties[6]	AAA	AAA	AAA	N/A	N/A

Notes:

1 & 2: The Upper and Middle Limits apply to appropriately rated banks and building societies.
3: The Other Institutions limit applies to other local authorities and supranational institutions (i.e. ECB).
4: Sterling, constant net asset value funds only.
5: The DMADF facility is direct with the UK government, it is extremely low risk and hence the higher limit.
6: UK investments are defined as those listed under UK banks or building societies in the Butler's counterparty listing.
7: Money limits apply to principal invested and do not include accrued interest.
8: Time Limits start on the trade date for the investment.

41. In the normal course of the Authority's cash flow operations it is expected that both specified and non-specified Investments will be utilised for the control of liquidity as both categories allow for short term investments. The Council will maintain a minimum £2M of investments in Specified Investments provided that the cashflow allows for this. In addition, although the Council will consider using non specified investments (as described in ***Appendix D1***), these should not exceed 50% of the portfolio at any one time. The limits applied will be consistent with the short and long term ratings in table 4 above.

42. The use of longer term instruments (greater than one year from trade date to maturity) and forward deals will not be used.

43. Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of the current 0.5% Bank Rate remaining flat but with the possibility of a rise in mid-2010. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts.

44. There is some operational difficulty arising from the current banking crisis, albeit that there is currently little value investing longer term and credit risk remains uncertain. Whilst some selective options do provide additional yield, uncertainty over counterparty creditworthiness indicates that shorter dated investments provide better security. As such, the time limit for upper limit investments has been further reduced to 3 months with middle limit institutions only being used for instant access.

45. The criteria for choosing counterparties set out above provide a sound approach to investment in "normal" market circumstances. Whilst Members are asked to approve the base criteria above, under the exceptional current market conditions the Head of Financial Services may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval. These restrictions will remain in place until the banking system returns to "normal" conditions. Similarly the time periods for investments will be restricted.

46. Examples of these restrictions include greater use of the Debt Management Deposit Account Facility (DMADF – a Government body which accepts local authority deposits), guaranteed deposit facilities and strongly rated institutions offered support by the UK Government as appropriate. The credit criteria reflect these facilities.

Risk benchmarking

47. A development in the revised Code and in Government consultation is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are new requirements for Member reporting, although the application of these is more subjective in nature. The purposes of the benchmarks are to aid Officer monitoring of the current and trend positions and to inform any amendments to the operational strategy and actions required, depending on any changes.

48. At present, the criteria set down in table 4 above and through the treasury management indicators below, limit activity in terms of length of deposit (liquidity) and in terms of strength of the counterparty (security). The current strategy follows on from the 2009/10 strategy in being low risk through, for example, restricting the amount and length of deposit in any one counterparty as well as mandating high liquidity on larger deposits. The use of benchmarking should allow the Council to set strategic parameters on investments that allow for an 'acceptable' level of risk in the portfolio, as set down by Members. The Council's treasury consultants, Butlers, have provided a method for quantifying the security and liquidity of the portfolio and this is currently under review. Detailed proposals will be included in subsequent reports to Members.

Treasury Management Indicators and Limits on Activity

49. There are four mandatory treasury management Indicators. The purpose of these indicators is to contain the activity of the treasury function within certain limits, thereby

managing risk and reducing the impact of an adverse movement in interest rates. The full list of Prudential Indicators is included elsewhere on the agenda, but the treasury management indicators are as follows:

- Upper limits on fixed interest rate exposure – This indicator identifies a maximum limit for fixed interest rates based upon the debt position net of investments.
- Upper limits on variable interest rate exposure – Similar to the previous indicator, this covers a maximum limit on variable interest rates.
- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.
- Total principal funds invested for greater than 364 days – given the current economic climate the Authority is not willing to risk investing sums for fixed terms of greater than 1 year and so this is £0.

50. Council will also be requested to approve the treasury management indicators, as updated in line with final budget proposals, at its meeting on 03 March 2010.

Table 5: Treasury Management Indicators

	2010/11		2011/12		2012/13	
Interest Rate Exposures						
	Upper		**Upper**		**Upper**	
Limits on exposure to fixed interest rates	100%		100%		100%	
Limits on exposure to variable interest rates	30%		30%		30%	
Maturity Structure of fixed interest rate borrowing						
	Lower	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	0%	35%	0%	35%	0%	35%
12 months to 2 years	0%	20%	0%	20%	0%	20%
2 years to 5 years	0%	20%	0%	20%	0%	20%
5 years to 10 years	0%	20%	0%	20%	0%	20%
10 years to 15 years	0%	50%	0%	100%	0%	100%
15 years to 25 years	0%	100%	0%	100%	0%	100%
25 years to 50 years	50%	100%	50%	100%	50%	100%
Actual current position						
Under 12 months	0%		0%		0%	
12 months to 2 years	0%		0%		0%	
2 years to 5 years	0%		0%		0%	
5 years to 10 years	0%		0%		0%	
10 years to 15 years	0%		0%		0%	
15 years to 25 years	0%		0%		0%	
25 years to 50 years	100%		100%		100%	
Maximum principal sums invested > 364 days						
Principal sums invested, in 2010/11, for periods of greater than 364 days, to mature after the end of each financial year	Nil		Nil		Nil	

Performance Indicators

51. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators that are predominantly forward looking. Examples of performance indicators often used for the treasury function are:

- Debt – Average rate movement year on year
- Investments – Internal returns above the 7 day LIBID rate

The results of these indicators will be reported in the Treasury Annual Report and the mid-year report as required under the new Code.

Treasury Management Advisers

52. The Council currently uses Butlers as its treasury management consultants. The company provides a range of services that include:

- technical support on treasury matters, capital finance issues and the drafting of Member reports;
- economic and interest rate analysis;
- debt services which includes advice on the timing of borrowing;
- debt rescheduling advice surrounding the existing portfolio;
- generic investment advice on interest rates, timing and investment instruments;
- credit ratings/market information service comprising the three main credit rating agencies;

53. Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remains with the Council. This service is subject to regular review.

Member and Officer Training

54. The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for Members and officers. This Council addresses this important issue by providing Member training in liaison with its treasury advisors and through ongoing training and supervision of officers involved the day to day operation of the treasury function.