DERBY CITY COUNCIL

COUNCIL CABINET
15 FEBRUARY 2011

ITEM 26

Report of the Strategic Director of Resources

Treasury Management Strategy and Prudential Code Indicators 2011/12

SUMMARY

1.1 This report outlines the Council's prudential indicators for 2011/12 – 2013/14 and sets out the expected treasury operations for this period. It fulfills four key legislative requirements:

- The reporting of the prudential indicators setting out the expected capital activities and treasury management activity as required by the CIPFA Prudential Code for Capital Finance in Local Authorities and the CIPFA Treasury Management Code of Practice.

- The setting out of the Council's Minimum Revenue Provision policy, determining how the Council will pay for capital assets through revenue each year as required by the Local Government and Public Involvement in Health Act 2007.

- The statement of the Council's treasury management strategy which sets out how the Council will support the capital strategy by managing day-to-day cashflow and placing limitations on activity through treasury prudential indicators. The key indicator is the 'Authorised Limit', the maximum amount of debt the Council could afford in the short term, but which would not be sustainable in the longer term. This is the Affordable Borrowing Limit required by section 3 of the Local Government Act 2003. This is in accordance with the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code and shown at Appendix 2.

- The investment strategy which sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss. This strategy is in accordance with the Department for Communities and Local Government's – CLG - Investment Guidance.

1.2 The above policies and parameters provide an approved framework within which Council officers will undertake the day-to-day capital and treasury activities. However, it is vital that Council members adopt an active role and scrutinise this framework according to their own concerns about the Council's finances, especially in light of the ongoing economic instability, and recent problems in the finance sector of both the UK and the rest of Europe.

RECOMMENDATION

Cabinet is recommended to approve each of the five key elements of this report, and recommend these to Council:

2.1 The Prudential Indicators and Limits for 2011/12 to 2013/14 contained within the Supporting Information of this report and summarised in Appendix 2.

2.2 The Minimum Revenue Provision - MRP - statement shown at paragraph 5.10 below, which sets out the Council's policy on MRP.

2.3 The Treasury Management Strategy 2011/12 to 2013/14, and the Treasury Management Prudential Indicators contained within Appendix 3.

2.4 The Authorised Limit Prudential Indicator shown in Appendix 3 paragraph 4.4.

2.5 The Investment Strategy 2011/12 contained in the treasury management strategy in Appendix 3, which recommends a slight relaxation of the investment limits set on the Council's current bank.

REASONS FOR RECOMMENDATION

3.1 It is considered good treasury management practice for members to monitor performance at least three times a year. This report covers treasury activity in the forthcoming financial year and thereby provides a benchmark for future activity.

SUPPORTING INFORMATION – PRUDENTIAL INDICATORS 2011/12 – 2013/14

4 Introduction

4.1 The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected capital activity or introduces measures of or limits upon that activity, and reflects the outcome of the Council's underlying capital appraisal systems. This report updates the currently approved indicators.

4.2 Within this overall prudential framework there is an impact on the Council's treasury management activity – as it will directly impact on borrowing or investment activity. As a consequence the treasury management strategy for 20011/12 to 2013/14 is included as Appendix C to complement these indicators. Some of the prudential indicators are shown in the treasury management strategy to aid understanding, and all are shown in the summary table at Appendix 2.

5 The Council's Capital Expenditure Plans

5.1 All capital expenditure needs to have regard to:

- Affordability (e.g. implications for the council tax)
- Service objectives (e.g. strategic planning)
- Stewardship of assets (e.g. asset management planning)
- Value for money (e.g. option appraisal)
- Prudence and sustainability (e.g. implications for external borrowing and whole life costing)
- Practicality (e.g. the achievability of the forward plan).

5.2 It is important to note that, with few exceptions, all capital expenditure decisions have an ongoing revenue impact which needs to be met from mainstream government grant or council tax.

5.3 The Council's capital expenditure plans are summarised below and this forms the first of the prudential indicators. A certain level of capital expenditure is funded by specific Government grant. Any decision by the Council to spend above this level is considered to be 'prudential' capital expenditure than impacts on revenue. This is because even 'supported' capital borrowing has an impact on council tax or services, as does any capital expenditure financed from revenue or capital receipts, since such funds could be used equally productively elsewhere in the Council's budget. This report covers the entire revenue implications of the Council's capital decisions.

5.4 The key risks to the plans are:

- the level of Government support for capital expenditure has been estimated and is therefore subject to change
- estimates for other sources of funding, particularly capital receipts due to the impact of the recession, may also be subject to change over this timescale.

5.5 Any reduction in funding from these sources will lead to an increased impact on council tax or a downward realignment of the Council's plans in line with available resources.

5.6 The Council is asked to approve the summary capital expenditure and sources of funding projections below. This forms the first prudential indicator:

Capital Expenditure	2010/11 Revised £m	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m
General Fund	71.5	102.4	62.7	71.2
HRA	16.4	17.4	10.9	9.1
Total	**87.9**	**119.8**	**73.6**	**80.3**
Financed by:				
Capital receipts	5.2	10.7	4.7	0.5
Capital grants	51.7	48.0	36.9	27.7
Use of reserves	12.3	0.7	0.2	0.0
Revenue contributions	3.0	8.8	2.9	0.8
Other contributions		2.1	0.3	0.3
Borrowing Requirement	**15.7**	**49.5**	**28.6**	**51.0**

5.7 The second prudential indicator is the Council's Capital Financing Requirement - CFR. The CFR is simply the total outstanding capital expenditure which has not yet been paid for from revenue or specific capital grant. It is essentially a measure of the Council's underlying borrowing need. The capital expenditure above which in financed by the borrowing requirement will increase the Council's CFR.

5.8 The Council is asked to approve the CFR projections below:

Capital Financing Requirement	2010/11 Revised £m	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m
General Fund	263.0	307.8	326.9	367.6
Housing Revenue Account	188.7	188.7	188.7	188.7
Total	451.6	496.5	515.6	556.3

5.9 The Council is required to pay off an element of the accumulated General Fund borrowing each year through a revenue charge known as the Minimum Revenue Provision (MRP). The Department of Communities and Local Government have issued regulations which require full Council to approve an MRP Statement in advance of each year.

5.10 The Council is recommended to approve the following MRP Statement (which is unchanged from last year):

- For capital expenditure incurred before 1 April 2008 or which in the future is Supported Capital Expenditure, the MRP policy will be to set aside a provision equal to 4% of the previous year's Capital Financing Requirement.
- From 1 April 2008 for all unsupported borrowing, excluding PFI and finance leases, the MRP policy will use the Asset Life Method on an annuity basis; ie. MRP will be based on the estimated life of the assets, with MRP being equal to the principal element of an annuity calculation based on a cost of capital deemed reasonable by the Corporate Director of Resources. The provision will be set aside in the year following the capital expenditure.
- For all PFI schemes and finance leases, the MRP will be equal to the element of the actual unitary charge or actual finance lease repayment that reduces the ongoing balance sheet liability, ie. the principal element of the charge or repayment, in line with CLG guidance.

6 Affordability Prudential Indicators

6.1 The previous sections cover the overall capital and borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

6.2 **Actual and Estimates of the ratio of financing costs to net revenue stream**
This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. This is a key performance indicator reflecting the net effect of the Council's capital programme and its cashflow management practices, and is therefore reported monthly to Chief Officers. The estimates of financing costs include current commitments and the proposals in this budget report.

	2010/11 Revised %	2011/12 Estimate %	2012/13 Estimate %	2013/14 Estimate %
General Fund	6.22	7.40	9.71	10.91
HRA	18.07	21.99	23.40	22.13

6.3 Members will notice that the ratio relevant to the General Fund (which covers capital expenditure financed by the council tax payer) is increasing, almost doubling over the next three years. This is due to the overall resources for the Council shrinking over this period, meaning that capital financing costs must be spread over a shorter base, despite the programme being reduced. By 2013/14 almost 11% of the Council's total resources will be spent servicing debt.

6.4 **Estimates of the incremental impact of capital investment decisions on the Band D Council Tax**
This indicator identifies the revenue costs associated with the three-year capital programme to 2013/14 proposed as part of the budget report and received at the same Council meeting as this report. The figures are cumulative and derived from the borrowing element of the capital programme (excluding 'spend to save' schemes which are assumed to be revenue neutral), together with any contributions from revenue that would otherwise reduce the Council Tax in Derby.

6.5 The table extends to 2014/15 as this is when the full impact of the proposed programme will be felt by Derby's council tax payers. The ongoing revenue costs arising from the years prior to 2011/12 are ignored for the purposes of this calculation, because the indicator must reflect the costs of only what is being proposed for members' approval. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support. The table below shows that the effect of Council adopting the three-year capital programme will add an estimated £125.75 to the band D council tax in Derby in 2011/12.

	2011/12 Estimate £	2012/13 Estimate £	2013/14 Estimate £	2014/15 Estimate £
Council Tax Band D Effect of adopting proposed capital programme	125.75	99.18	106.50	114.07

6.6 **Estimates of the incremental impact of capital investment decisions on Council Housing Rent levels**

This is similar to the Council Tax calculation. The indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in this budget report compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels. This indicator shows the revenue impact on any newly proposed changes, although in practice any impact will be constrained by rent restructuring.

	2011/12 Estimate £	2012/13 Estimate £	2013/14 Estimate £	2014/15 Estimate £
Weekly Housing Rent levels Effect of adopting proposed capital programme	3.12	2.18	0.22	0.21

OTHER OPTIONS CONSIDERED

7.1 None.

This report has been approved by the following officers:

Legal officer **Financial officer** **Human Resources officer** **Service Director(s)** **Other(s)**	Roger Kershaw, Strategic Director of Resources

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Background papers:	The Revised Prudential Code for Capital Finance in Local Authorities, CIPFA
List of appendices:	Appendix 1 - Implications Appendix 2 - Summary of Prudential Indicators 2009/10 – 2013/14 Appendix 3 - Treasury Management Strategy 2011/12 Annex 3A – Treasury Management Practice 1 Annex 3B – Security, Liquidity and Yield Benchmarking

IMPLICATIONS

Financial

1.1 The prudential indicators contained in the report highlight the financial and associated risk implications of decisions made elsewhere by the Council. In particular, the key prudential indicator – the ratio of financing costs to net revenue stream – highlights the increasing cost to tax payers of the Council's ongoing capital programme.

Legal

2.1 The report fulfils the legislative requirements as set out in the summary.

Personnel

3.1 The Prudential Code places responsibilities on staff involved in treasury management, requiring regular training and briefings and the acquisition of usable market knowledge with a view to maximising the return whilst ensuring the security of the Council's investments. It is important that the Council regularly assesses the budgetary and personnel provision it makes for such training and knowledge.

Equalities Impact

4.1 None.

Health and Safety

5.1 None.

Carbon commitment

6.1 The contents of this report do not impact significantly on the amount of CO_2 produced by the Council or its partners. However, it should be noted that the Council undertakes no monitoring of the environmental impact of the investments made by its counterparties.

Value for money

7.1 The objective of the Council's Treasury Management Strategy is both to highlight and reduce the ongoing revenue costs of the Council's capital programme and thereby contribute to providing value-for-money services to the citizens of Derby.

Corporate objectives and priorities for change

8.1 The treasury management practices adopted by the Council ensure that it delivers value for money across all services (objective COD2). This value is achieved by minimising the borrowing costs driven by the capital programme, and by maximising (within the constraints of security and liquidity) the return on any invested cash surpluses.

Prudential Code Indicators Summary 2010/11 - 2013/14 **Appendix 2**

Revised Prudential Code Reference	Indicator	Estimated 2010/11	Estimated 2011/12	Estimated 2012/13	Estimated 2013/14
Affordability					
	Financing cost to Net Revenue Stream Ratio				
36-37	- General Fund %	6.22%	7.40%	9.71%	10.91%
77-78	- HRA %	18.07%	21.99%	23.40%	22.13%
38	**Cumulative Incremental Impact on Council Tax: Band D £**	0.00	125.75	99.18	106.50
79	**Incremental Impact on Housing Rents £/week - year's programme**	0.22	3.12	2.18	0.22
Prudence					
	Actual/Forecast Borrowing compared to CFR				
43	- Gross External Debt £m	311.5	410.4	430.9	472.6
	- Investment Balances £m	-55.1	-20.0	-20.0	-20.0
	- CFR £m	451.6	496.5	515.6	556.3
	- Variance £m	-195.2	-106.1	-104.7	-103.7
Local	- Gross External Debt £m	311.5	410.4	430.9	472.6
	- Transferred Debt £m	38.0	36.5	35.0	33.7
	- Investment Balances £m	-55.1	-20.0	-20.0	-20.0
		294.4	426.9	445.9	486.3
	- CFR £m	451.6	496.5	515.6	556.3
	- Variance £m	-157.2	-69.6	-69.7	-70.0
Capital Expenditure					
	Total Capital Expenditure				
46-48	- General Fund £m	71.5	102.4	62.7	71.2
81-82	- HRA £m	16.4	17.4	10.9	9.1
	- Total £m	87.9	119.8	73.6	80.3
	Capital Financing Requirement				
49-52	- General Fund £m	263.0	307.8	326.9	367.6
83-84	- HRA £m	188.7	188.7	188.7	188.7
	- Total £m	451.6	496.5	515.6	556.3
External Debt					
53	Authorised Limit for borrowing £m	542	517	536	627
	Authorised Limit for other long term liabilities £m	100	50	50	50
	Authorised Limit £m	642	567	586	677
54	Operational Boundary for borrowing £m	472	447	466	557
	Operational Boundary for other long term liabilities £m	100	50	50	50
	Operational Boundary £m	572	497	516	607
58	**Actual External Debt £m**	311.5	410.4	430.9	472.6
Treasury Management					
60	**Adopted CIPFA TM Code of Practice and Cross-Sectoral Guidance Notes (2009)**	Yes	Yes	Yes	Yes
Local	**Interest Rate Exposure - Fixed**				
	Upper limit %	120	120	120	120
	Lower limit %	80	80	80	80
Local	**Interest Rate Exposure - Variable**				
	Upper limit %	20	20	20	20
	Lower limit %	-20	-20	-20	-20
Local	**Long term Borrowing - Fixed rate**				
	Upper limit %	100	100	100	100
	Lower limit %	80	80	80	80
Local	**Long term Borrowing - Variable rate**				
	Upper limit %	20	20	20	20
	Lower limit %	0	0	0	0
Local	**Investments - Fixed rate**				
	Upper limit %	100	100	100	100
	Lower limit %	30	30	30	30
Local	**Investments - Variable rate**				
	Upper limit %	70	70	70	70
	Lower limit %	0	0	0	0
Local	**Maturity Structure of Debt - % of all debt (Limits shown in place of estimates)**				
	Up to 1 year	5%	5%	5%	5%
	Up to 2 years	10%	10%	10%	10%
	Up to 5 years	20%	20%	20%	20%
	Up to 10 years	50%	50%	50%	50%
	Up to 20 years	70%	70%	70%	70%
	Up to 30 years	80%	80%	80%	80%
	Up to 40 years	90%	90%	90%	90%
	Up to 50 years	100%	100%	100%	100%
Local	**Investments over a year - limit £m**	£10m	£0m	£0m	£0m
Local	**Investments over two years - limit £m**	£0m	£0m	£0m	£0m

Treasury Management Strategy 2011/12 - **Including Annual Investment Strategy**

1 Introduction

1.1 The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators summarised in Appendix 2 consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury management service considers the effective funding of these decisions. Together they form part of the process which ensures the Council meets its balanced budget requirement under the Local Government Finance Act 1992.

1.2 The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management – revised November 2009). This Council originally adopted the Code of Practice on Treasury Management in 2002, and has since adopted the revised Code.

1.3 The Treasury Management Strategy outlines expected treasury activity for the next three years, and covers:

- the Council's debt and investment projections
- the Council's estimates and limits on future debt levels
- the expected movement in interest rates
- the Council's borrowing and investment strategies
- Treasury performance indicators
- specific limits on treasury activities.

2 Affordability of Capital Programme

2.1 As a result of all the treasury management activity covered in the strategy and highlighted in the list above, the Key Performance Indicator for treasury management is the overall cost of the function compared to the Council's overall available resources. This is known as the 'Ratio of Financing Costs to Net Revenue Stream' and this is reported to chief officers on a monthly basis as well as to members. It is a key ratio because increases in it point to a decrease in the sustainability of the Council's capital programme, although there is no absolute limit at which the programme could be deemed 'unsustainable' – such a judgement must be made within the round of the Council's overall revenue budget.

2.2 The table in paragraph 6.2 in the main body of the report shows how the Ratio of Financing Costs to Net Revenue Stream is forecast to change over the next three years. The steep rise in this ratio is due mainly to the shrinking resource base of the Council, meaning that – relative to the Council's revenue resources – the cost of the capital programme is increasing by 75% between 2010/11 and 2013/14 (from 6.22% to 10.91%).

3 Debt and Investment Projections 2011/12 – 2013/14

3.1 The borrowing requirement comprises the expected movement in the CFR, mainly from additions to the capital programme, and any maturing debt which will need to be re-financed, less amounts being set-aside from the Council's revenue budget for the future repayment of debt.

3.1.1 The table below shows the effect of this on the treasury management debt position over the next three years:

External Debt	**2010/11 Revised £m**	**2011/12 Estimate £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**
External debt at 31 March	311.5	410.4	430.9	472.6
Transferred debt at 31 March	38.0	36.5	35.0	33.7
Total debt 31 March	349.5	446.9	465.9	506.3

3.1.2 The table below highlights the expected level of investment balances, given the movement in the CFR and Council's intention to delay borrowing for as long as possible:

Investments	**2010/11 Revised £m**	**2011/12 Estimate £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**
Total Investments at 31 March	55.1	20.0	20.0	20.0
Average investment balances for the year	78.4	41.0	41.0	41.0

3.2 The related impact of the above movements on the revenue budget is:

	2010/11 Revised £m	**2011/12 Estimate £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**
Revenue Budgets				
Interest on Borrowing	14.0	17.2	20.8	22.9
Less: HRA recharge	-7.8	-8.8	-9.6	-9.8
Net Borrowing Cost	**6.2**	**8.4**	**11.2**	**13.1**
Gross Investment income	0.4	0.2	0.2	0.2

4 Limits to Borrowing Activity

4.1 Within the prudential indicators there are a number of key indicators to ensure the Council conducts its activities within well-defined limits. For the first of these the Council needs to ensure that its total borrowing net of any investments does not, except in the short term, exceed the total of the Capital Financing Requirement in the preceding year plus the estimates of any additional CFR for 2011/12 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that long-term borrowing is not undertaken for revenue purposes.

	2010/11 Revised £m	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m
Gross Borrowing	311.5	410.4	430.9	472.6
+ Transferred Debt	38.0	36.5	35.0	33.7
- Investments	-55.1	-20.0	-20.0	-20.0
= Net Borrowing	294.4	426.9	445.9	486.3
CFR	451.6	496.5	515.6	556.3
Headroom	157.2	69.6	69.7	70.0

4.2 The Strategic Director of Resources can report that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future, as shown by the planned £70m headroom in the table above. This planned 'under-borrowing' stems partly from the current trends within financial markets which make holding on to cash costly, and is not meant to represent an ideal position any more than over-borrowing would. In order to avoid the cost of carrying debt, the Council no longer borrows in anticipation of capital expenditure reported in the Capital Strategy report, but only as and when such cash in required. Clearly, this exposes the Council to some interest rate risk, but – given the current revenue constraints – this is in practical terms unavoidable.

4.3 Two further key prudential indicators represent a control on the overall level of borrowing and indebtedness:

- the Authorised Limit for External Debt represents a limit beyond which external debt is prohibited, and this limit needs to be set and revised by full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, provides headroom for rescheduling (i.e. borrowing in advance of repayment), but is not sustainable in the longer term. This is the statutory limit determined under section 3(1) of the Local Government Act 2003.

- the Operational Boundary is the level of borrowing that, if exceeded frequently, would indicate a potential problem with the borrowing strategy, but by itself does not represent an unaffordable level of borrowing.

4.4 The Council is asked to approve the following Authorised Limit and Operational Boundary:

	2010/11 Revised £m	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m
Borrowing	542.0	517.0	536.0	627.0
Other long-term liabilities	100.0	50.0	50.0	50.0
Authorised Limit	**642.0**	**567.0**	**586.0**	**677.0**
Borrowing	472.0	447.0	466.0	557.0
Other long-term liabilities	100.0	50.0	50.0	50.0
Operational Boundary	**572.0**	**497.0**	**516.0**	**607.0**

The other long-term liabilities shown in the table above mainly represent finance leases taken out by the Council as part of PFI contracts. Given the availability of relatively cheap loans from the Public Works Loan Board (PWLB) it is not Council policy to enter into finance leases for capital acquisition. However, the leases wrapped up in PFI contracts are allowable exceptions to this, since the finance lease costs are normally covered by PFI grant.

4.5 Though it is permitted to, in recent years the Council has not borrowed in advance of the current year's capital programme because the cost of carrying the cash in advance of spend is too high. Borrowing rates of around 5% and investment rates of around 0.5% mean that every £1m of advance borrowing would cost the Council £45,000 a year. Equally, postponing such borrowing will result in a short-term saving.

5 Market Forces and Expected Movement in Interest Rates

5.1 There is significant uncertainty with economic forecasts. Whilst short-term rates are expected to remain on hold through most of 2011, inflationary concerns are increasing. Inflation has been above the 2% target for so long the credibility of the Bank of England's Monetary Policy Committee (MPC) may become a greater focus. This will make the MPC's decisions, regarding whether to control inflation or continue to aid the recovery during 2011, a difficult judgment. The MPC will be particularly concerned that the public's inflation expectations could become unhinged, and so there is a risk that the MPC may feel the need to take action earlier than the fourth quarter of the year.

5.2 The recovery in the economy is well underway. However, the strong rates of growth we have seen are unlikely to be sustained. The Government's determination to cut the size of the public sector deficit will be a drag upon activity in the medium term. The void left by significant cuts in public spending will need to be filled by a number of alternatives – corporate investment, rising exports (assisted by the fall in the value of sterling) and consumers' expenditure. In terms of sheer magnitude, the latter is the most important and strong growth in this area is by no means certain. The combination of the desire to reduce the level of personal debt, lack of access to credit and continued job uncertainty is likely to weigh heavily upon spending. This will be amplified by the fiscal policy tightening, as announced in the most recent Spending Review. Without growth in personal spending remaining robust, any recovery in the economy is set to be weak and protracted.

5.3 Fiscal support in the US through the extension of tax cuts and monetary support through the extension of Quantative Easing has had an adverse impact on world bond markets. Following the recent sell-off the outlook for long-term interest rates is favourable in the near term, but is set to deteriorate again in the latter part of 2011. The increase in yields will be suppressed by continued investor demand for safe-haven instruments following the uncertainties and unfolding tensions within the entire Eurozone. In addition to this, the market has been underpinned by evidence of moderating activity in major economies and the coalition government's determination to deal with the parlous state of public sector finances. These two factors will restrict any deterioration in longer term fixed interest rates in the near term.

5.4 However, while the UK's fiscal burden will almost certainly ease, it will be a lengthy process and deficits over the next two to three financial years will still require a very heavy programme of gilt issuance. The latest Bank Inflation Report suggests the market will not be able to rely upon Quantitative Easing indefinitely to alleviate this enormous burden. Eventually, the absence of the Bank of England as a continued 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.

5.5 This incentive will take the form of higher yields. The longer end of the curve 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.

5.6 Although the FSA has recently delayed implementation of their liquidity requirements, the regulator will still look to ensure banks have necessary short term liquidity. The front end of the curve will benefit from this and will ensure the steeply-positive incline of the yield curve remains intact.

6 Borrowing Strategy 2011/12 – 2013/14

6.1 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.

6.2 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 Strategic Director of Resources, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, 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/medium term.

6.3 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. The Strategic Director of Resources and treasury consultants will monitor prevailing rates for any opportunities during the year. However, following the recent Spending Review the PWLB increased borrowing interest rates by approximately 1%, without changing debt redemption interest rates. This will make PWLB debt rescheduling more problematic in the future.

6.4 The more attractive option of postponing future borrowing for as long as possible, and thereby running down investment balances, is likely to be pursued by Derby in the short term. This would have the double benefit of reducing counterparty risk and hedging against the expected fall in investments returns.

7 Investment Strategy 2011/12 – 2013/14

7.1 The Council's investment strategy objectives are here listed in order of priority:

- To safeguard principal sums invested and to ensure that interest payable on such sums is paid on time.
- To ensuring adequate liquidity.
- To maximise the rate of return on investments.

As a result of the underlying concerns with the current economic climate Council treasury management officers are continuing to implement an operational investment strategy which maintains the tight controls already in place in the approved investment strategy.

7.2 Yield benchmarks are currently widely used to assess investment performance. However, discrete security and liquidity benchmarks are relatively new requirements for the purposes of Member reporting, although the application of these is more subjective in nature. Additional background in the approach taken by the Council is attached at Annex 3B.

7.3 These benchmarks are simple targets (not limits) and so may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is to ensure that officers monitor the current and trend position and amend the operational strategy depending on any changes. Any breach of the benchmarks will be reported, with supporting reasons, in the Mid-Year or Annual Report as appropriate.

7.4 Security - The Council's maximum security risk benchmark for the current investment portfolio, when compared to historic default tables, is:

- 0.08% historic risk of default when applied to the whole portfolio.

On a £100m portfolio this would equate to a loss of £80,000 but this figure is only notional and does not constitute any expectation of loss. The Council, with the assistance of its treasury advisors, monitors changes to risk ratings and manages its portfolio accordingly, with a view to avoiding any loss of principal.

7.5 Liquidity – In respect of this area the Council seeks to maintain:

- Bank overdraft - £50,000
- Liquid short term deposits of at least £20m available with instant access.
- Weighted Average Life benchmark is expected to be around 0.25 years, with a maximum of 2 years.

7.6 Yield – In the wake of the general banking crisis the Council no longer aims to out-perform any yield benchmark, investing only in line with the security and liquidity benchmarks highlighted above. However, for information at year end the 7 day London Inter Bank Bid Rate (LIBID) can be used for comparison with the Council's investments. Indeed, the Council pays out interest on internal balances based on this interest rate.

7.7 The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure that:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.
- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

7.8 The Strategic Director of Resources 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. These criteria are separate to those which apply to Specified and Non-Specified investments as they provide an overall pool of counterparties considered high quality that the Council may use.

7.9 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 the lending criteria. This is in compliance with a CIPFA Treasury Management Panel recommendation in March 2009 and the CIPFA Treasury Management Code of Practice.

7.10 Credit rating information is supplied by our treasury consultants (currently Sector) on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be excluded from the counterparty 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. For instance, a negative rating watch applying to a counterparty at the minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions. Amounts invested with any counterparty that is removed from the Council's list are withdrawn at the earliest possible time.

7.11 Occasionally a live counterparty (that is, one in which the Council has a current investment) will be removed from the approved list. This is especially so with Derby, given its quite tight counterparty criteria; institutions can fall below our standards and still be considered quite safe by the market. In such instances where live counterparties are unexpectedly removed from the Council's approved list, officers maintain a watchful eye on any outstanding investment and update their system such that no further investments can be placed. On the very rare occasion of a live counterparty experiencing liquidity problems, the Strategic Director of Resources – in consultation with the Council's treasury management advisors – would attempt to negotiate the return of the Council's principal, although this could well result in financial penalties being exacted on the Council. To date the Council has experienced no such problem with any counterparty.

7.12 The proposed criteria for providing a pool of high quality investment counterparties for investments are shown in the table below. This table applies both to UK financial institutions which have received ratings from the three main ratings agencies Fitch, Moody's and Standard & Poor's, as well as to other counterparties in which the Council might invest. It should be noted that for groups of counterparties (eg. all the banks that belong to the Royal Bank of Scotland Group), the limit applying to the group will be the maximum limit which applies to any member of that group.

Investment criteria

Short term rating	Long term rating	Individual rating	Support rating	Maximum period	Limit
F1	AA	C	3	1 year	£12m
F1	A	C	3	3 months	£8m
F1	A	"Eligible"	3	3 months	£5m
• Co-operative Bank (Council's current bank)				Overnight	£5m
• Debt Management Office				6 months	n/a
• AAA rated Money Market Funds (>£20bn)				n/a	£20m
• AAA rated Money Market Funds (>£10bn)				n/a	£15m
• AAA rated Money Market Funds (>£5bn)				n/a	£10m
• AAA rated Money Market Funds (>£1bn)				n/a	£5m
• Other local authorities				n/a	£15m
• UK Government guaranteed institutions				Period of guarantee	£12m

7.13 The Council uses entities deemed "Eligible Institutions" under the HM Treasury Credit Guarantee Scheme announced in October 2008, with the necessary short, long term and Support ratings in the Short-term investments table above. These institutions have been subject to suitability checks before inclusion, and have access to HM Treasury liquidity if needed. The Individual / Financial category has been removed as these only review an entity on a stand-alone basis. The UK support packages are taken into account in the short and long term ratings

7.14 The Council's own bank, the Co-operative, is currently included for investments up to £1m. It is proposed to increase this limit to £5m, since during the course of the business day the balance in the Council's current account can reach levels of up to £15m (prior to a monthly payroll run). It is important to note that this is not in line with the general counterparty limits as they apply to the rest of the financial market – an exception is being made to reflect the Co-operative's status as the Council's current bank – which means that investments placed with the Co-operative Bank fall into the 'non-specified' investment category (see annex 3A below).

7.15 No investment limit is placed on the Bank of England's Debt Management Office (DMO), as this is the safest place for the Council to place its cash and the remote possibility still exists that at some point in the future the Council will find that it cannot place cash anywhere without breaching a limit.

7.16 The proposed criteria for Specified and Non-Specified investments are shown in Annex 3A for approval. In the normal course of the council'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.

7.17 Longer term instruments (greater than one year from inception to repayment) automatically fall into the non-specified investment category. These are now precluded by the limit set on investments (see paragraph 3.46 below). Whilst there is nothing inherently unsafe about longer term investments, it does not make sense for the Council to tie its cash up in such investments since this will make borrowing more likely. The current policy is for the Council to avoid the 'cost of carry' by delaying borrowing for as long as possible.

7.18 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, the Strategic Director of Resources may - under exceptional market conditions - restrict further investment activity. Such restrictions will remain in place until the banking system returns to "normal" conditions. Similarly the time periods for investments will be restricted. These restrictions would usually result in greater use of the Debt Management Office, which offers the safest haven for investments and lowest rate of return (currently 0.25%).

7.19 The table below highlights the estimated impact on the general fund of a 1% increase/decrease in all interest rates to the estimated treasury management costs/income for both 2010/11 (estimated in last year's report) and 2011/12. Please note: elements of the debt and investment portfolios which are of a longer-term, fixed-interest rate nature will not be affected by interest rate changes. Note also that the impact of an increase in the borrowing rate will be higher in 2012/13, since there is only a part-year effect in 2011/12.

Effect of increasing interest rates by 1%	**2010/11 impact on budget £m**	**2011/12 impact on budget £m**	**2012/13 impact on budget £m**
Interest on borrowing	0.117	0.231	0.567
Investment income	-0.452	-0.158	-0.158

7.20 There are four further treasury activity limits, which were previously prudential indicators. The purpose of these are 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. However if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance.

7.21 The indicators are:

- Upper limits on variable interest rate exposure – This identifies a maximum limit for variable interest rates based upon the debt position net of investments.
- Upper limits on fixed interest rate exposure – Similar to the previous indicator this covers a maximum limit on fixed 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 – These limits are set with regard to the Council's liquidity requirements, and are based on the availability of funds after each year-end.

7.22 The Council is therefore asked to approve the following interest rate exposure limits for 2011/12:

	Upper Limit	**Lower Limit**
Net debt - fixed interest rate exposure	120%	80%
Net debt - variable interest rate exposure	20%	-20%
Borrowing - fixed interest rate exposure	100%	80%
Borrowing - variable interest rate exposure	20%	0%
Investments - fixed interest rate exposure	100%	30%
Investments - variable interest rate exposure	70%	0%

7.33 The Council is also asked to approve the limits on maturity structures as set out in the table below. The borrowing limits are designed to prevent too much debt maturing in any given year, which if this were to occur would greatly expose the Council to interest rate risk on the replacement borrowing. No borrowing in excess of 50 years can be undertaken. For information the actual debt maturity structure for the year ended 31 March 2010 is shown.

Borrowing	**Upper Limit**	**Actual 2009/10**
Up to 1 year	15.00%	2.66%
Up to 2 years	30.00%	2.67%
Up to 5 years	45.00%	2.68%
Up to 10 years	75.00%	6.45%
Up to 20 years	80.00%	13.54%
Up to 30 years	90.00%	28.80%
Up to 40 years	95.00%	47.82%
Up to 50 years	100.00%	100.00%

7.34 In addition to these borrowing limits, the Council is also asked to approve the upper limit of £0m on investments placed for periods of greater than 1 year. In other words, it is proposed that no further investments for greater than 1 year are made, effectively aligning Council policy with current practice.

7.35 The Council uses Sector (after our previous advisers, Butlers, were taken over by them in 2010) as its treasury management consultants. Sector provides a range of services which 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 data from the three main credit rating agencies and international financial markets.

Sector’s contract with the Council expires on 31 March 2011, at which point it will be re-let through a competitive process.

7.36 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.

Treasury Management Practice (TMP) 1 – Credit and Counterparty Risk Management

1.1 The CLG issued Investment Guidance in 2010, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds which are under a different regulatory regime.

1.2 The key intention of the Guidance is to maintain the current requirement for Councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council will apply its principles to all investment activity. In accordance with the Code, the Strategic Director of Resources has produced its treasury management practices (TMPs). This part, TMP 1(5), covering investment counterparty policy requires approval each year.

1.3 The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of following:

- The strategy guidelines for choosing and placing investments, particularly non-specified investments.
- The principles to be used to determine the maximum periods for which funds can be committed.
- Specified investments the Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
- Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

1.4 The investment policy proposed for the Council is:

1.4.1 Strategy Guidelines – The main strategy guidelines are contained in the body of the treasury strategy statement.

1.4.2 Specified Investments – These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments which would not be defined as capital expenditure with:

- The UK Government (such as the Debt Management Account deposit facility, UK Treasury Bills or a Gilt with less than one year to maturity).
- Supranational bonds of less than one year's duration.
- A local authority, parish council or community council.
- Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. This covers pooled investment vehicles, such as money market funds, rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.

- A body that is considered of a high credit quality (such as a bank or building society).

Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies which will be invested in these bodies. These limits are shown in the body of the report at appendix 3.

1.4.3 Non-Specified Investments – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non specified investments would include any sterling investments in:

- Supranational bonds greater than 1 year to maturity
- Gilt-edged securities
- The Council's own bank, since this falls short of the general criteria specified in appendix 3.
- Building societies not meeting these same criteria
- A non-rated subsidiary of an institution included with the specified investment category
- Share capital or loan capital
- Pooled property
- Investments in share capital, loan capital or pooled property will only be considered after obtaining external advice and subsequent member approval.

1.5 The Monitoring of Investment Counterparties - The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Sector as and when ratings change, and counterparties are checked promptly.

Security, Liquidity and Yield Benchmarking

1.1 A proposed development for member reporting is the consideration and approval of security and liquidity benchmarks. These benchmarks are targets, not limits, and so may be breached from time to time. Any breach will be reported, with supporting reasons, in the mid-year Progress Report or the Annual Treasury Report as appropriate.

1.2 Yield – These benchmarks are currently widely used by a number of local authorities and benchmarking clubs to assess investment performance. However, in the wake of the general banking crisis the use of such benchmarks was identified as a factor that could lead to increased investment risk, and so the Council no longer benchmarks yield on a close basis, preferring instead to benchmark the overall cost of its net borrowing (which takes investment income into account) as a proportion of its overall revenue resources. However, in the annual report to members the yield position will be reported and compared to the 7 day LIBID rate.

1.3 Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. Further benchmarks for the Council's investments are set out below and these form the basis of routine reporting in this area.

1.4 Liquidity – This is defined as "having adequate, though not excessive cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives" (CIPFA Treasury Management Code of Practice). In respect of this area the Council seeks to maintain:

- Bank overdraft - £50,000.
- Liquid short term deposits of at least £20m available with instant access.
- Weighted Average Life (WAL) benchmark is expected to be 0.5 years, with a maximum of 2 years. A shorter WAL would generally embody less risk.

1.5 Security of the investments – In context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard & Poor's). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy. The table below shows average defaults for differing periods of investment grade products for each Fitch long term rating category over the period 1990 to 2009.

Years	1	2	3	4	5
AAA	0.00%	0.01%	0.05%	0.10%	0.17%
AA	0.03%	0.06%	0.08%	0.14%	0.20%
A	0.08%	0.22%	0.37%	0.52%	0.70%
BBB	0.24%	0.68%	1.19%	1.79%	2.42%
BB	1.22%	3.24%	5.34%	7.31%	9.14%
B	4.06%	8.82%	12.72%	16.25%	19.16%
CCC	24.03%	31.91%	37.73%	41.54%	45.22%

1.6 The Council's minimum short term rating criteria is currently "A", meaning the average expectation of default for a one year investment in a counterparty with a long-term rating of "A" would be 0.08%. However, this is only a statistical expectation – it is no guarantee of future performance and any specific counterparty loss is likely to be substantial. These figures simply act as a proxy benchmark for risk across the portfolio.

1.7 If the Council's worst-case security risk benchmark is 0.08%, this equates to a maximum risk of £80,000 on an investment portfolio of £100m. This benchmark is embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members in the Treasury Management Annual Report.