DERBY CITY COUNCIL

COUNCIL CABINET
16 FEBRUARY 2010

ITEM XX

Report of the Corporate Director of Resources

Treasury Management Strategy and Prudential Code Indicators 2010/11

SUMMARY

1.1 This report outlines the Council's prudential indicators for 2010/11 – 2012/13 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 as required by the CIPFA Prudential Code for Capital Finance in Local Authorities as shown at Appendix 1. The treasury management prudential indicators are now included as treasury indicators in the CIPFA Treasury Management Code of Practice.

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

- The treasury management strategy statement which sets out how the Council's treasury service will support the capital decisions taken above, the day-to-day treasury management and the 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 and also shown in Appendix 2.

1.2 Revised editions of the CIPFA Prudential Code and CIPFA Treasury Management Code of Practice were produced in November 2009. CLG is currently consulting on changes to the Investment Guidance. The revised guidance arising from these Codes has been incorporated within these reports, with the CLG proposals being incorporated where these do not conflict with current Guidance. If necessary the Investment Strategy contained in Appendix 3 will be revised if any elements of the final CLG Investment Guidance have not already been covered.

1.3 The main changes initiated in the revisions above, increase the Council members' responsibility in this area. This would require greater member scrutiny of the treasury policies, increased member training and awareness and greater frequency of information.

1.4 One element of the revised CIPFA Treasury Management Code of Practice is that the clauses to be adopted as part of the Council's Financial Procedure Rules (section E7) be amended. This revision is shown at Annex 3C for approval. The key change is that a responsible body – the Audit and Accounts Committee - be responsible for ensuring effective scrutiny of the treasury management strategy and policies, before making recommendations to Council.

1.5 The above policies and parameters provide an approved framework within which Council officers will undertake the day-to-day capital and treasury activities.

RECOMMENDATIONS

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

2.1 The Prudential Indicators and Limits for 2010/11 to 2012/13 contained within Appendix 2 of the report.

2.2 The Minimum Revenue Provision (MRP) statement contained within Appendix 2 paragraph 2.8 which sets out the Council's policy on MRP.

2.3 The Treasury Management Strategy 2010/11 to 2012/13, and the Treasury Prudential Indicators contained within Appendix 3.

2.4 The Authorised Limit Prudential Indicator shown in paragraph 3.14.

2.5 The Investment Strategy 2010/11 contained in the treasury management strategy in Appendix 3.

2.6 The revision to the Council's Financial Procedure Rules (section E7) at Annex 3C. This revision nominates the Audit and Accounts Committee as the body responsible for ensuring effective scrutiny of the treasury management strategy and policies.

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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 - Prudential Indicators 2010/11 – 2012/13 Annex 2A – Summary of Prudential Indicators 2008/09 – 2012/13 Appendix 3 - Treasury Management Strategy 2010/11 Annex 3A – Treasury Management Practice 1 Annex 3B – Security, Liquidity and Yield Benchmarking Annex 3C – Amendment to Financial Procedure Rules

IMPLICATIONS

Financial

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

Personnel

3. The revised Prudential Code places additional responsibilities on staff involved in treasury management, requiring additional training and briefings and the acquisition of further market knowledge with a view to maximising the return whilst ensuring the security of the Council's investments. The Council is still at an early stage in the implementation of such processes and the impact on staff resources and personnel implications are still to be assessed.

Equalities impact

4. None.

Corporate objectives and priorities for change

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

PRUDENTIAL INDICATORS 2010/11 - 2012/13

1 Introduction

1.1 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 limits upon that activity, and reflects the outcome of the Council's underlying capital appraisal systems. This report updates currently approved indicators and introduces new indicators for 2012/13.

1.2 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 20010/11 to 2012/13 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 Annex 2A.

2 The Council's Capital Expenditure Plans

2.1 All capital expenditure needs to have regard to:

- 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);
- Affordability (e.g. implications for the council tax and council house rents);
- Practicality (e.g. the achievability of the forward plan).

The revenue consequences of capital expenditure will need to be paid for from the Council's own resources.

2.2 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 supported by Government grant; any decision by the Council to spend above this level is by definition considered to be unsupported capital expenditure. However, even 'supported' capital expenditure has an impact on council tax or services, as does any capital expenditure financed from revenue or capital receipts, since the resources providing the capital support could be used equally productively elsewhere within the Council's revenue budget. This report therefore covers the entire revenue implications of the Council's capital decisions, whether considered unsupported or not.

2.3 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.

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.

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

Capital Expenditure	2009/10 Revised £m	2010/11 Estimate £m	2011/12 Estimate £m	2012/13 Estimate £m
General Fund	70.2	81.9	98.7	164.8
HRA	27.4	22.2	13.3	11.6
Total	**97.6**	**104.1**	**112**	**176.4**
Financed by:				
Capital receipts	5.3	9.8	6.1	4.7
Capital grants	63.1	50.7	60.9	96.5
Use of reserves	9.8	12.8	2.8	0.9
External contributions	6.1	3.3	0.7	0.3
Borrowing Requirement	**13.4**	**27.6**	**41.4**	**74.0**

2.5 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 either revenue or capital resources. It is essentially a measure of the Council’s underlying borrowing need. The capital expenditure above which has not immediately been paid for will increase the CFR.

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

Capital Financing Requirement	2009/10 Revised £m	2010/11 Estimate £m	2011/12 Estimate £m	2012/13 Estimate £m
CFR – Non Housing	213.2	332.4	365.5	430.6
CFR - Housing	188.7	188.7	188.7	188.7
Total CFR	402.0	521.1	554.3	619.4

2.7 The Council is required to pay off an element of the accumulated General Fund capital spend each year through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake additional voluntary payments (VRP). CLG Regulations have been issued which require full Council to approve an MRP Statement in advance of each year. A variety of options are provided to councils to replace the existing Regulations, so long as there is a prudent provision.

2.8 The Council is recommended to approve the following MRP Statement …

- 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.

2.9 At the time of writing this report the full extent of MRP costs associated with PFI schemes and finance leases is not known, as these need to be determined in line with International Financial Reporting Standards, IFRS. When these are known, the corresponding prudential indicators will be revised and a subsequent report taken to Cabinet and Council. Members should be advised that, under IFRS, PFI schemes and finance leases will introduce unfinanced assets relating to schools and street lighting onto the Council's balance sheet. This will have the effect of increasing the Council's borrowing costs – with a corresponding decrease in service revenue budgets - and have an upward impact on the Council's CFR and other prudential indicators.

Affordability Prudential Indicators

2.10 The previous sections cover the overall capital and control of 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:

2.11 **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 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.

	2009/10 Revised %	2010/11 Estimate %	2011/12 Estimate %	2012/13 Estimate %
Non-HRA	8.19	8.40	9.32	10.68
HRA	17.42	17.15	17.63	18.28

2.12 **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 (ie. excluding the £14m allocated to "future years" spend on the Leisure Centre Strategy) 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. The table extends to 2013/14 as this is when the full impact of the proposed programme will be felt by our council tax payers. The ongoing revenue costs arising from the years prior to 2009/10 are ignored for the purposes of this calculation. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period. The table below shows that the effect of adopting the three-year capital programme will add an estimated £141.38 to the band D council tax in Derby.

	2010/11 Estimate £	2011/12 Estimate £	2012/13 Estimate £	2013/14 Estimate £
Council Tax Band D – Effect of adopting proposed capital programme	51.21	57.83	100.33	141.38

2.13 **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.

	2009/10 Revised £	2010/11 Estimate £	2011/12 Estimate £	2012/13 Estimate £
Weekly Housing Rent levels	1.77	3.79	3.20	1.98

Prudential Code Indicators Summary 2008/09 - 2012/13

Annex 2A

Revised Prudential Code Reference	Indicator	Actual 2008/09	Estimated 2009/10	Estimated 2010/11	Estimated 2011/12	Estimated 2012/13	Estimated 2013/14
Affordability							
	Financing cost to Net Revenue Stream Ratio						
36-37	- General Fund %	5.96%	8.19%	8.40%	9.32%	10.68%	
77-78	- HRA %	23.03%	17.42%	17.15%	17.63%	18.28%	
38	**Cumulative Incremental Impact on Council Tax: Band D £**	n/a	n/a	51.21	57.83	100.33	141.38
79	**Incremental Impact on Housing Rents £/week - year's programme**	1.88	1.77	3.79	3.20	1.98	
Prudence							
	Actual/Forecast Borrowing compared to CFR						
43	- Net External Debt £m	215.8	234.4	278.3	342.3	407.3	
	- Transferred Debt £m	41.3	39.6	38.0	36.5	35.0	
	- CFR £m	396.8	502.0	521.1	554.3	619.4	
	- Variance £m	-139.7	-227.9	-204.8	-175.4	-177.0	
Local	- Gross External Debt £m	343.3	285.4	329.3	362.3	427.3	
	- Transferred Debt £m	41.3	39.6	38.0	36.5	35.0	
	- CFR £m	396.8	502.0	521.1	554.3	619.4	
	- Variance £m	-12.2	-176.9	-153.8	-155.4	-157.0	
Capital Expenditure							
	Total Capital Expenditure						
46-48	- General Fund £m	81.7	83.9	93.8	97.3	157.0	
81-82	- HRA £m	11.0	12.0	15.0	9.5	8.6	
	- Total £m	92.7	95.9	108.8	106.8	165.6	
	Capital Financing Requirement						
49-52	- General Fund £m	208.0	313.2	332.4	365.5	430.6	
83-84	- HRA £m	188.7	188.7	188.7	188.7	188.7	
	- Total £m	396.8	502.0	521.1	554.3	619.4	
External Debt							
53	Authorised Limit for borrowing £m	495	475	542	575	640	
	Authorised Limit for other long term liabilities £m	1	100	100	100	100	
	Authorised Limit £m	496	575	642	675	740	
54	Operational Boundary for borrowing £m	425	405	472	505	570	
	Operational Boundary for other long term liabilities £m	1	100	100	100	100	
	Operational Boundary £m	426	505	572	605	670	
58	**Actual External Debt £m**	343.3	285.4	329.3	362.3	427.3	
Treasury Management							
60	**Adopted CIPFA Treasury Management Code of Practice**	Yes	Yes	Yes	Yes	Yes	
Local	**Interest Rate Exposure - Fixed**						
	Upper limit %	120	120	120	120	120	
	Actual %	113.57					
	Lower limit %	80	80	80	80	80	
Local	**Interest Rate Exposure - Variable**						
	Upper limit %	20	20	20	20	20	
	Actual %	-13.57					
	Lower limit %	-20	-20	-20	-20	-20	
Local	**Long term Borrowing - Fixed rate**						
	Upper limit %	100	100	100	100	100	
	Actual %	100.00					
	Lower limit %	80	80	80	80	80	
Local	**Long term Borrowing - Variable rate**						
	Upper limit %	20	20	20	20	20	
	Actual %	0.00					
	Lower limit %	0	0	0	0	0	
Local	**Investments - Fixed rate**						
	Upper limit %	100	100	100	100	100	
	Actual %	72.52					
	Lower limit %	30	30	30	30	30	
Local	**Investments - Variable rate**						
	Upper limit %	70	70	70	70	70	
	Actual %	27.48					
	Lower limit %	0	0	0	0	0	
Local	**Maturity Structure of Debt - % of all debt (Limits shown in place of estimates)**						
	Up to 1 year	2.33%	5%	5%	5%	5%	
	Up to 2 years	5.28%	10%	10%	10%	10%	
	Up to 5 years	5.31%	20%	20%	20%	20%	
	Up to 10 years	5.31%	50%	50%	50%	50%	
	Up to 20 years	11.51%	70%	70%	70%	70%	
	Up to 30 years	31.03%	80%	80%	80%	80%	
	Up to 40 years	51.13%	90%	90%	90%	90%	
	Up to 50 years	100.00%	100%	100%	100%	100%	
Local	**Investments over a year - limit £m**	£25m	£25m	£10m	£10m	£10m	
Local	**Investments over two years - limit £m**	£0m	£0m	£0m	£0m	£0m	

Treasury Management Strategy 2010/11 - **Including Annual Investment Strategy**

3.1 The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators in Appendix B consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury 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.

3.2 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 adopted the Code of Practice on Treasury Management in 2002, and will adopt the revised Code.

3.3 As a result of adopting the Code, the Council also adopted a Treasury Management Policy Statement in 2002. This adoption is one of the requirements of the prudential indicators. However, the revised Code of Practice has amended the Treasury Management Policy Statement and this is appended at Annex C3 for approval.

3.4 The Financial Procedure Rules (section E7) require an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming 3 years. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced after the year-end to report on actual activity for the year. There is a new requirement of the revision of the Code of Practice to produce a mid-year monitoring report, but the Council already receives such a report in November each year.

3.5 This strategy 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.

3.6 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 currently defined absolute limit at which the programme could be deemed 'unsustainable'.

3.7 The table below shows how the Ratio of Financing Costs to Net Revenue Stream is forecast to change over the next three years:

	Actual 2008/09	Forecast 2009/10	Forecast 2010/11	Forecast 2011/12	Forecast 2012/13
Ratio of Financing Costs to Net Revenue Stream	5.96%	8.19%	8.40%	9.32%	10.68%

3.8 As highlighted in paragraph 2.9 above, the impact of International Financial Reporting Standards may result in existing revenue costs being reclassified as finance lease costs. This would have an upward impact on this key indicator, without there being a net cost increase, and – when known – this will be conveyed to members in a future report.

Debt and Investment Projections 2010/11 – 2012/13

3.9 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. The table below shows this effect on the treasury position over the next three years. The table also highlights the expected level of investment balances.

	2009/10 Revised £m	**2010/11 Estimated £m**	**2011/12 Estimated £m**	**2012/13 Estimated £m**
External Debt				
External debt at 31 March	285.4	329.3	362.3	427.3
Transferred debt at 31 March	39.6	38.0	36.5	35.0
Total debt 31 March	325.0	367.3	398.8	462.3
Investments				
Total Investments at 31 March	51.0	51.0	20.0	20.0
Average investment balances for the year	99.4	72.0	41.0	41.0

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

	2009/10 Revised £m	**2010/11 Estimated £m**	**2011/12 Estimated £m**	**2012/13 Estimated £m**
Revenue Budgets				
Interest on Borrowing	12.8	14.2	16.3	19.2
Less: HRA recharge	-7.3	-7.7	-8.3	-8.6
Net Borrowing Cost	**5.5**	**6.5**	**8.0**	**10.6**
Investment income	1.1	0.3	0.2	0.1

Limits to Borrowing Activity

3.11 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 2010/11 and the following two financial years (the relevant comparative figures are highlighted). This allows some flexibility for limited early borrowing for future years, but ensures that long-term borrowing is not undertaken for revenue purposes.

	2009/10 Revised £m	2010/11 Estimate £m	2011/12 Estimate £m	2012/13 Estimate £m
Gross Borrowing	285.4	329.3	362.3	427.3
+ Transferred Debt	39.6	38.0	36.5	35.0
- Investments	-51.0	-51.0	-20.0	-20.0
= Net Borrowing	274.0	316.3	378.8	442.3
CFR	502.0	521.1	554.3	619.4

3.12 The Corporate Director of Resources reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future, as shown 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. Please note that the CFR estimate for 2009/10 onwards has also been inflated by £100m to account for any leases that might be reclassified as finance leases under IFRS. Once the actual value of these leases is known, the CFR will be modified in a future report to members.

3.13 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.

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

	2009/10 Revised £m	2010/11 Estimate £m	2011/12 Estimate £m	2012/13 Estimate £m
Borrowing	475.0	442.0	475.0	540.0
Other long-term liabilities	100.0	100.0	100.0	100.0
Authorised Limit	**575.0**	**542.0**	**575.0**	**640.0**
Borrowing	405.0	372.0	405.0	470.0
Other long-term liabilities	100.0	100.0	100.0	100.0
Operational Boundary	**505.0**	**472.0**	**505.0**	**570.0**

Again members should note that the long-term liabilities figure for 2009/10 and future years has been increased from £1m to £100m in order to take account of International Financial Reporting Standards. These Standards require the obligations under some PFI contracts to be reclassified as finance leases. Previously the Council treated these as operational leases, and their reclassification represents an increase in the Council's overall indebtedness.

3.15 The Council has some flexibility to borrow funds this year for use in future years. The Corporate Director of Resources may do this under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. Whilst the Corporate Director of Resources will adopt a cautious approach to any such borrowing, where there is a clear business case for doing so, borrowing may be undertaken to fund the approved capital programme or to fund future debt maturities.

3.16 Any borrowing in advance will be made within the constraints that:

- it will be limited to no more than 50% of the expected increase in borrowing need over the three year planning period; and
- it would not look to borrow more than 12 months in advance of need.

In recent years the Council has not borrowed in advance of the current year's capital programme. However, due to programme slippage at the year end it has occasionally found itself having 'over borrowed' for the current year, resulting in the surplus borrowing being carried over and held against the following year's requirement. Due to the Council's large-scale redemption of debt during 2008/09 and 2009/10 this is unlikely to be repeated in future years. In any case risks associated with any advance borrowing activity will be subject to appraisal in advance and subsequent reporting through the mid-year or annual reporting mechanism.

Market Forces and Expected Movement in Interest Rates

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

3.18 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.

3.19 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 recent return of the rate of VAT to 17.5% and the proposed increase in National Insurance. Without a rebound in this key element of UK growth, any recovery in the economy is set to be weak and protracted.

3.20 The Bank of England Monetary Policy Committee (MPC) will continue to promote easy credit conditions via QE. QE has been extended to a total of £200bn and there is still an outside chance that it could be expanded further in February 2010. 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.

3.21 With inflation set to remain subdued in the next few years, the pressure upon the MPC to raise rates will remain moderate. But some increase will be seen as necessary in 2010 to counter the effects of external cost pressures (as commodity prices begin to rise again) and to avoid damage that sterling could endure if the UK is seen to defy an international move to commence policy exit strategies.

3.22 Longer term rates are expected to be more volatile. The current 'softness' of gilt yields and PWLB rates may continue for a while yet, given that these are being driven by a benign international backdrop and the effects of QE. Nevertheless this process will come to an end before the close of the financial year, which is likely to herald a return to rising yields for a number of reasons:

- Net gilt issuance will rise sharply;
- This will be increased by the extent to which the Band of England attempts to claw back funds injected to the economy via the QE programme;
- Investors will be looking to place more of their funds in alternative instruments as their risk appetite increases, demand for gilts will weaken as a consequence;
- A decision to leave QE in place will generate inflation concerns and pressurise long yields higher.

Borrowing Strategy 2010/11 – 2012/13

3.23 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.

3.24 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 Corporate 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.

3.25 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 Corporate Director of Resources and the Council's treasury consultants will monitor prevailing rates for any opportunities during the year.

3.26 The option of postponing borrowing and running down investment balances has been pursued by the Council for the last year. This has had the benefit of reducing counterparty risk and hedge against the sharp fall in investments returns. However, the benefits of such a strategy must be shared with the HRA which loses subsidy as a consequence, and so there is a limit to how far this strategy can be pursued.

Investment Strategy 2010/11 – 2012/13

3.27 The Council's investment strategy primary objectives are safeguarding the re-payment of the principal and interest of its investments on time first and ensuring adequate liquidity second, the rate of return being a third objective. Following the economic background 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 implementing an operational investment strategy which maintains the tight controls already in place in the approved investment strategy.

3.28 A development in the revised Codes and the CLG consultation paper 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 to the Member reporting, although the application of these is more subjective in nature. Additional background in the approach taken is attached at Annex C2.

3.29 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 that officers will 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.

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

- 0.03% historic risk of default when applied to the whole portfolio.

On a £100m portfolio this would equate to a loss of £30,000 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.

3.31 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.

3.32 Yield – In the wake of the Icelandic 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.

3.33 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.

3.34 The Corporate 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.

3.35 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 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.

3.36 Credit rating information is supplied by our treasury consultants 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.

3.37 The proposed criteria for providing a pool of high quality investment counterparties for *short-term* (ie. less than 365 days) 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.

Short-term investments

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
• Debt Management Office				6 months	n/a
• AAA rated Money Market Funds				n/a	£15m
• Other local authorities				n/a	£15m
• UK Government guaranteed institutions				Period of guarantee	£12m

3.38 The Council will use entities deemed "Eligible Institutions" under the HM Treasury Credit Guarantee Scheme initially announced on 13 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

3.39 The Council's own bank, the Co-operative, is currently excluded by the above criteria, as its short-term rating was downgraded to F2 in August 2009 following its merger with the Britannia Building Society. This has meant that any monies held at the Co-operative Bank need to be cleared out by the Council and invested elsewhere by the close of play on each banking day, so as not to breach investment limits.

3.40 As the Council has tightened its lending criteria over the past two years it has become increasingly difficult to place surplus cash without breaching investment limits. For this reason the limit for investments placed with the Debt Management Office (part of the Bank of England) was increased in July 2009 to £75m. However, it makes no sense to apply any limit to the 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. It is therefore proposed to remove the DMO investment limit, and at the same time notionally applying a time limit of 6 months.

3.41 To ensure that the Council is minded of the long-term viability of any counterparty with which it places a short term investment, a minimum long-term rating of "A" is now also applied to these counterparties.

3.42 The current criteria for long-term investments are as follows, and it is not proposed to amend these:

Long-term investments

Short term rating	Long term rating	Individual rating	Support rating	Maximum period	Limit
-	AA	A/B	1	2 year	£10m

3.43 Additional requirements under the Code of Practice now require the Council to supplement credit rating information. Whilst the above criteria rely 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 (for example Credit Default Swaps, equity price movements, etc) will be applied to compare the relative security of differing investment counterparties where available.

3.44 The proposed criteria for Specified and Non-Specified investments are shown in Annex C1 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.

3.45 Longer term instruments (greater than one year from inception to repayment) automatically fall into the non-specified investment category. These instruments will only be used where the Council's liquidity requirements are safeguarded. This will also be limited by the longer term investment limits.

3.46 Expectations on shorter-term interest rates, on which investment decisions are based, show 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.

3.47 There is an operational difficulty arising from the current banking crisis. There is currently little value investing longer term unless credit quality is reduced. Whilst some selective options do provide additional yield uncertainty over counterparty creditworthiness suggests shorter dated investments would provide better security.

3.48 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 Corporate Director of Resources 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. Examples of these restrictions would be the greater use of the Debt Management Office, Money Market Funds, guaranteed deposit facilities and strongly rated institutions offered support by the UK Government.

3.49 Future Council accounts will be required to disclose the impact of risks on the Council's treasury management activity. Whilst most of the risks facing the treasury management service are addressed elsewhere in this report (credit risk, liquidity risk, market risk, maturity profile risk), the impact of interest rate risk is discussed but not quantified. 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 next year. That element of the debt and investment portfolios which are of a longer term, fixed interest rate nature will not be affected by interest rate changes.

Effect of increasing interest rates by 1%	**2010/11 Estimated impact on budget £m**
Interest on borrowing	0.117
Investment income	-0.452

3.50 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.

3.51 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 to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

3.52 The Council is asked to approve the following interest rate exposure limits:

	Limits 2010/11 %	**Limits 2011/12 %**	**Limits 2012/13 %**
Net debt - fixed interest rate exposure - Upper - Lower	 120 80	 120 80	 120 80
Net debt - variable interest rate exposure - Upper - Lower	 20 -20	 20 -20	 20 -20
Borrowing - fixed interest rate exposure - Upper - Lower	 100 80	 100 80	 100 80
Borrowing - variable interest rate exposure - Upper	 20	 20	 20

- Lower	0	0	0
Investments - fixed interest rate exposure - Upper - Lower	 100 30	 100 30	 100 30
Investments - variable interest rate exposure - Upper - Lower	 70 0	 70 0	 70 0

3.53 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 2009 is shown.

Borrowing	**Upper Limit**	**Actual 08/09**
Up to 1 year	15.00%	2.33%
Up to 2 years	30.00%	5.28%
Up to 5 years	45.00%	5.31%
Up to 10 years	75.00%	5.31%
Up to 20 years	80.00%	11.51%
Up to 30 years	90.00%	31.03%
Up to 40 years	95.00%	51.13%
Up to 50 years	100.00%	100.00%

3.54 This shows that in March 2009 approximately 49% of the Council's debt was set to mature between 40 and 50 years hence, pushing a large amount of interest rate risk comfortably into the long-term. However, all the Council's debt is actively managed by officers and restructuring opportunities are sometimes undertaken which can bring debt maturities forward. This generates savings for the Council but at the expense of increasing shorter-term interest rate risk. Such risk is also actively managed and contained within the Council's treasury management budget.

3.55 In addition to these borrowing limits, the Council is also asked to approve the lower limit of £10m cash limit on investments placed for periods of greater than 1 year. Such investments are necessarily classed as non-specified because of the inherent risk of placing long-term deals irrespective of the counterparty used. No investment can be placed with a maturity date in excess of 2 years.

Investments	
Principal sums invested > 1 year	£10m
Principal sums invested > 2 years	£0m

3.56 The Council uses Butlers as its treasury management consultants. The company 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.

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.

3.57 The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are adequately time-resourced, well trained and kept up-to-date requires a suitable staffing and training process for Members and officers. This Council has addressed this important issue by:

- arranging treasury training for members of the Audit and Accounts Committee
- providing professional training to the treasury management accountant through the Association of Corporate Treasurers
- benchmarking treasury staff time with neighbouring and comparable local authorities
- encouraging officers to attend treasury management seminars and conferences provided by Butlers or CIPFA.

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

4.1 The Office of the Deputy Prime Minister (now CLG) issued Investment Guidance in 2004, and this forms the structure of the Council's policy below. The CLG is currently consulting over revisions to the Guidance and where applicable the Consultation recommendations have been included within this policy. These guidelines do not apply to either trust funds or pension funds which are under a different regulatory regime*.*

4.2 The key intention of the Guidance is to maintain the current requirement for Councils to invest prudently, and ensure 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, a revised second edition of which was issued in 2009. In approving this report the Council will formally adopt the revised Code and will apply its principles to all investment activity.

4.3 In accordance with the Code, the Corporate Director of Resources has reproduced its treasury management practices - TMPs. TMP 1, covering investment counterparty policy, requires approval each year. 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 quality (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.

4.4 The investment policy proposed for the Council is …

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

- **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 Office, 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 that have been awarded a high credit rating by a credit rating agency. This covers 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). This covers bodies with a minimum short term rating of F1 (or the equivalent) as rated by Standard and Poor's, Moody's or Fitch rating agencies. 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 and these are defined in the table in paragraph 3.40 in the Treasury management Strategy above.

- **Non-Specified Investments** – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The only non-specified investments permitted by the Council's investment strategy are:
  - Overnight investments with the Co-operative Bank, so long as the credit rating of the Co-operative Bank fall below the minimum specified in the table in paragraph 3.40 in the Treasury Management Strategy above.
  - Investments placed with or committed to any counterparty meeting the minimum credit rating criteria but with a maturity date exceeding 364 days.

4.5 The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Butlers as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Corporate Director of Resources, and if required new counterparties which meet the criteria will be added to the list.

Security, Liquidity and Yield Benchmarking

5.1 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.

5.2 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 Icelandic 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. In the annual report to members the yield position will be reported and compared to the 7 day LIBID rate.

5.3 Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. However they have not previously been separately and explicitly set out for Member consideration. Proposed benchmarks for the cash type investments are below and these will form the basis of future reporting in this area.

5.4 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.

5.5 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 and 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 2007.

Long term rating	1 year	2 years	3 years	4 years	5 years
AAA	0.00%	0.00%	0.00%	0.00%	0.00%
AA	0.00%	0.00%	0.00%	0.03%	0.06%
A	0.03%	0.15%	0.30%	0.44%	0.65%
BBB	0.24%	0.78%	1.48%	2.24%	3.11%

5.6 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 0.03%. 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.

5.7 The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables, is 0.03%, which equates to a maximum risk of £50,000 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.

Treasury Management Clauses to form part of the Council's Financial Procedure Rules

6.1 Derby City 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, 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.

6.2 Derby City 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 Treasury Management Practices.

6.3 Derby City Council delegates responsibility for the implementation and monitoring of its treasury management policies and practices to the Cabinet, and for the execution and administration of treasury management decisions to the Corporate Director of Resources, who will act in accordance with the Council's policy statement and Treasury Management Practices and CIPFA's Standard of Professional Practice on Treasury Management.

6.4 The organisation nominates the Audit & Accounts Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.