WYRE FOREST DISTRICT COUNCIL

CABINET
16TH FEBRUARY 2010

The Prudential System of Local Government Finance and the Treasury Management Policy and Strategy Report 2010/2011

OPEN	
SUSTAINABLE COMMUNITY STRATEGY THEME:	-
CORPORATE PLAN THEME:	Improving Corporacy & Performance
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1. PURPOSE OF REPORT

1.1 To provide Members with background information on the Chartered Institute of Public Finance (CIPFA) Prudential Code for Capital Finance in Local Authorities (Prudential Code).

1.2 To seek approval for the Prudential Indicators and Limits for the financial years 2010/2011 to 2012/2013 and set out the expected treasury operations for this period.

1.3 To seek approval for the Council's Treasury Management Strategy for the financial year 2010/2011 which sets out how the Council's treasury service will support the capital decisions taken, 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 s3 of the Local Government Act 2003 and is in accordance with the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code.

1.4 To seek approval for the Council's Investment Policy and Strategy for the financial year 2010/2011 which sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss.

1.5 Revised editions of the CIPFA Prudential Code and CIPFA Treasury Management Code of Practice were produced in November 2009.The 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 the Appendices will be revised if any elements of the final CLG Investment Guidance have not already been covered.

1.6 This proposed strategy has been scrutinised and endorsed by the Treasury Management Review Panel on 4th February 2010. This panel, established following the collapse of the banks with Icelandic connections, is now responsible for ensuring effective scrutiny of the treasury management strategy and policies, before Cabinet makes recommendations to Council. This is in compliance with the revised CIPFA Treasury Management Code of Practice and accordingly recommendations are now made to update the Financial Regulations/Constitution to reflect the new scrutiny requirements.

1.7 To fulfil four key legislative requirements:

- The reporting of the Prudential Indicators as required by the CIPFA Prudential Code;
- The Treasury Management Strategy in accordance with the CIPFA Code of Practice on Treasury Management and CIPFA Prudential Code;
- The Investment Policy and Strategy (in accordance with Communities and Local Government (CLG) investment guidance);
- The Minimum Revenue Provision (MRP) Policy (as required by Regulation under the Local Government and Public Involvement in Health Act 2007).

2. RECOMMENDATIONS

The Cabinet RECOMMENDS to Council to:

2.1 Adopt the updated Prudential Indicators and Limits for 2009/10 Revised, 2010/2011 to 2012/2013.

2.2 Approve the updated Treasury Management and Investment Policy and Strategy 2010/2011, the associated Prudential Indicators and the detailed criteria included in Appendix 6.

2.3 Approve the Minimum Revenue Provision (MRP) Statement that sets out the Council's policy on MRP.

2.4 Approve the Authorised Limit Prudential Indictor.

2.5 Revisit, as part of Budget Monitoring, the Prudential Indicators following the approval of the Council's Budget Strategy as the indicators included within this report are based on current recommendations.

2.6 To continue to keep the current Treasury Management Practices (TMP) under review with the assistance of the Council's Treasury Consultants.

2.7 Amend the Financial Regulations and Constitution to adopt the recommended clauses in the revised CIPFA Treasury Management Code of Practice issued in November 2009 as set out in Appendix 9 and Section 10 of this Report.

3. THE CAPITAL PRUDENTIAL INDICATORS 2009/2010 TO 2012/2013

3.1 BACKGROUND

3.1.1 The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. This report revises the indicators for 2009/2010, 2010/2011 and 2011/2012, and introduces new indicators for 2012/2013. Each indicator either summarises the expected activity or introduces limits upon the activity, and reflects the outcome of the Council's underlying capital appraisal systems.

3.1.2 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 2010/11 to 2012/13 is included in this report to complement these indicators. Some of the prudential indicators are shown in the treasury management strategy to aid understanding.

3.2 CAPITAL EXPENDITURE

3.2.1 The Council's capital expenditure plans are summarised below and this forms the first of the prudential indicators. This expenditure can be funded (by resources such as capital receipts, capital grants ,borrowing, direct revenue financing etc.), but if resources are insufficient any residual expenditure will form a borrowing need as it will be considered unsupported capital expenditure. This unsupported 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 rents);
- Practicality (e.g. the achievability of the forward plan).

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

3.2.3 This capital expenditure can be paid for immediately (by applying capital resources such as capital receipts, capital grants etc., or revenue resources), but if these resources are insufficient any residual capital expenditure will add to the Council's borrowing need.

3.2.4 The key risks to the plans are that the level of Government support has been estimated and is therefore maybe subject to change. Similarly some estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale. For instance anticipated asset sales may be postponed due to the impact of the recession on the property market.

3.2.5 The Council is asked to approve the summary capital expenditure projections below. Service details are contained within the Capital Programme Report in the Financial Strategy 2010/2013 booklet, adjusted for slippage identified in the Quarter 3 Budget Monitoring Cabinet Report. This forms the first prudential indicator:

£'000	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
Capital Expenditure	8,197	11,006	9,995	3,382
Financed by:				
Capital receipts	5,912	2,520	7,424	110
Future Capital Receipts	500	5,090	0	0
Capital grants	1,334	1,361	809	429
Revenue	84	98	0	0
Net financing need for the year	**367**	**1,937**	**1,762**	**2,843**

3.3 <u>THE CAPITAL FINANCING REQUIREMENT (the Council's Borrowing Need)</u>

3.3.1 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 Council's underlying borrowing need. The capital expenditure above which has not immediately been paid for will increase the CFR.

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).

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. The Council is recommended to approve the following MRP Statement:

- For capital expenditure incurred before 1 April 2008 or which in the future will Supported Capital Expenditure, the MRP policy will be:

  Existing practice - MRP will follow the existing practice outline in former CLG Regulations

- From 1 April 2008 for all unsupported borrowing the MRP policy will be:

  Asset Life Method – MRP will be based on the estimated life of the assets, in accordance with the proposed regulations (this option must be applied for any expenditure capitalised under a Capitalisation Directive)

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

Capital Financing Requirement £'000	**2009/10 Revised**	**2010/11 Estimated**	**2011/12 Estimated**	**2012/13 Estimated**
Total CFR	1,709	2,888	3,751	5,533
Movement in CFR	120	1,179	863	1,782

Movement in CFR represented by				
Net financing need for the year (above)	367	1,937	1,762	2,843
MRP and other financing movements	(487)	(758)	(899)	(1,061)
Total movement in CFR	**120**	**1,179**	**863**	**1,782**

3.4 THE USE OF THE COUNCIL'S RESOURCES AND THE INVESTMENT POSITION

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year end balances for each resource and anticipated day to day cash flow balances.

Year End Resources £'000	2009/10 Original	2009/10 Revised	2010/11 Estimate	2011/12 Estimate	2012/13 Estimate
Fund balances	1,320	1,106	1,203	476	0
Capital receipts	11,247	10,221	7,701	227	167
Other balances available for Investment	3,433	3,173	3,996	3,597	3,033
Total Core Funds	**16,000**	**14,500**	**12,900**	**4,300**	**3,200**
Working Capital*	1,000	1,500	1,600	1,700	1,800
Expected Investments	17,000	16,000	14,500	6,000	5,000

*Working capital balances shown are estimated year end; these may be higher mid year

3.5 AFFORDABILITY PRUDENTIAL INDICATORS

3.5.1 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 overall Council's finances. The Council is asked to approve the following indicators:

3.5.2 **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.

%	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
Ratio	(2.09)	3.38	4.45	6.32

3.5.3 The estimates of financing costs include current commitments and the proposals in the base Financial Strategy 2010/2013.

3.5.4 **Estimates of the incremental impact of capital investment decisions on the Council Tax** – This indicator identifies the revenue costs associated with ***new schemes*** proposed, as part of the three year capital programme recommended in the base Financial Strategy 2010/2013 compared to the Council's existing approved commitments and current plans. 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.

3.5.5 **Incremental impact of capital investment decisions on the Band D Council Tax**

£	Proposed Budget 2010/11	Forward Projection 2011/12	Forward Projection 2012/13
Council Tax - Band D	(0.37)	(3.45)	(4.59)

4. TREASURY MANAGEMENT STRATEGY 2010/2011 TO 2012/2013

4.1 BACKGROUND

4.1.1 The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators 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 the balanced budget requirement under the Local Government Finance Act 1992. There are specific treasury prudential indicators included in this strategy that require approval.

4.1.2 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). This Council adopted the Code of Practice on Treasury Management on 27th February 2003 C90 (10), and as a result adopted a Treasury Management Policy Statement (Executive 13th February 2003 ED.223) and will adopt the November 2009 revision of the Code. This adoption meets the requirements of the first of the treasury prudential indicators. However, the revised code of practice has amended the Treasury Management Policy Statement set out in Appendix 2.

4.1.3 The Constitution and Financial Regulations (as updated by this report) requires that an annual strategy is 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, and a new requirement of the revision of the Code of Practice is that there is a mid year monitoring report.

4.1.4 Since October 2008, there has been significant attention in this area following the collapse of banks with which the Council had a total of £9m invested. Following the collapse of these banks the Council undertook a thorough Treasury Management Review process and the findings of this review were presented to the Cabinet on 19 February 2009. A further Treasury Management Update report was taken to Cabinet on 21 July 2009 to extend the Counterparties with whom the Council can place investments since the lending list had become unmanageable. This proposed Treasury Management Strategy takes into account revisions of the CIPFA Prudential Code and CIPFA Treasury Management Code of Practice. It has been considered by the Treasury Management Review Panel and includes recommendations from the scrutiny of this Review Panel.

4.1.5 This strategy covers:

- The Council's debt and investment projections;
- The Council's estimates and limits of future debt levels;
- The expected movement in interest rates;
- The Council's borrowing and investment strategies;
- Treasury performance indicators;

- Specific limits on treasury activities;
- Any local treasury issues.

4.2 DEBT AND INVESTMENT PROJECTIONS 2010/2011 TO 2012/2013

4.2.1 The borrowing requirement comprises the expected movement in the CFR 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 expected maximum debt position during each year represents Operational Boundary prudential indicator, and so may be different from the year end position. It also highlights the expected change in investment balances.

£'000	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
External Debt				
Debt at 31 March	36	34	1,114	3,099
Operational Boundary	800	800	2,000	5,000
Investments				
Investments at 31 March	(8,788)	(9,435)	(2,412)	(2,769)
Icelandic Investments at 31 March (currently 'frozen') *	(7,212)	(5,065)	(3,588)	(2,231)
Total Investments at 31 March	(16,000)	(14,500)	(6,000)	(5,000)

* The Financial Strategy anticipates the return of the Council's investments. This will be re-invested as appropriate taking into account the approved investment limits.

4.2.2 The related impact of the above movements on the revenue budget are:

£'000	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
Revenue Budgets				
Interest on Borrowing	2	5	7	164
Investment income	(141)	(218)	(195)	(175)

4.3 LIMITS TO BORROWING ACTIVITY

4.3.1 Within the prudential indicators there are a number of key indicators to ensure the Council operates its activities within well defined limits.

4.3.2 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 CFR in the preceding year plus the estimates of any additional CFR for 2010/2011 and the next two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

£'000	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
Gross Borrowing	36	34	1,114	3,099
Investments	(8,788)	(9,435)	(2,412)	(2,769)
Icelandic Investments (currently 'frozen') *	(7,212)	(5,065)	(3,588)	(2,231)
Net Investment position	(15,964)	(14,466)	(4,886)	(1,901)
CFR	1,709	2,888	3,751	5,533

* The Financial Strategy anticipates the return of the Council's investments. This will be re-invested as appropriate taking into account the approved investment limits.

4.3.3 The Director of Resources reports that the Council complied with the prudential indicator detailed in 4.3.2 in the current year and is projected to comply with this indicator for the future three years. This view takes into account current commitments, existing plans, and the proposals in the base Financial Strategy 2010/2013. It should be noted that from 2012/13 onwards there will be a requirement to undertake external borrowing to fund the housing capital programme as the expenditure is incurred. As a consequence, there is a higher level of CFR shown in 2012/13. However, this borrowing requirement has not yet been factored into the Operational Boundary expectations as the exact timing of the external borrowing is uncertain.

4.3.4 A further two prudential indicators control or anticipate the overall level of borrowing. These are:

- **The Authorised Limit for External Debt** – This represents a control on the overall level of borrowing and a limit beyond which external debt is prohibited. The limit needs to be set or revised by full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, 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 Government retains an option to control either the total of all councils' plans, or those of a specific council, although no control has yet been exercised.
- **The Operational Boundary for External Debt** –This indicator is based on the expected maximum external debt during the course of the year; it is not a limit.

4.3.5 The Council is asked to approve the following Authorised Limits :

Authorised Limit £'000	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
Borrowing	5,000	6,000	9,000	10,000
Other long term liabilities	0	0	0	0
Total	5,000	6,000	9,000	10,000

4.4 EXPECTED MOVEMENT IN INTEREST RATES

4.4.1 The current position of the treasury function, and its expected change in the future, introduces risk to the Council from an adverse movement in interest rates. The

Prudential Code is constructed on the basis of affordability, part of which is related to borrowing costs and investment returns. The Council employs Butlers, the treasury consultants, to advise on the treasury strategy, to provide economic data and interest rate forecasts, to assist planning and reduce the impact of unforeseen adverse movements.

4.4.2 The UK economy has entered a profound recession, worsened by a dangerous combination of negative growth and dislocation in the domestic and world financial markets. The situation in the economy is considered critical by the policy setters who are concerned that the testing financial environment, the sharp decline in house prices and persistently tight credit conditions could trigger a collapse in consumer confidence. At worst this could deliver a prolonged Japanese-style recession.

4.4.3 The expected movement in interest rates are as follows:

Medium-Term Rate Estimates (averages) – 2008/2013

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

* Borrowing Rates

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

2. 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. The main drag upon the economy is expected to be weak consumers' expenditure growth. The combination of the desire to reduce the level of personal debt and job uncertainty is likely to weigh heavily upon spending. This will be amplified by the prospective increases in taxation already scheduled for 2010 – VAT and National Insurance. Without a rebound in this key element of UK GDP growth, any recovery in the economy is set to be weak and protracted.

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

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

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

7. The programme might well end in February, especially if the economy has returned to a recovery path as seems very likely. With growth back on the agenda and inflation challenging the upper limit of the Government's target range, the majority of MPC members may feel enough assistance has been given to ensure lack of credit is no longer a fundamental threat to the welfare of the economy.

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

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

4.5 BORROWING STRATEGY 2010/2011 TO 2012/2013

4.5.1 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. It is not anticipated that the Council will undertake external borrowing until 2012/13.

4.5.2 However, long-term fixed interest rates are at risk of being higher over the medium term. The 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 better opportunities.

4.5.3 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, although the Director of Resources and treasury consultants will monitor prevailing rates for any opportunities during the year.

4.5.4 The option of postponing borrowing and running down investment balances could also be considered. This would reduce counterparty risk and hedge against the expected fall in investments returns.

4.5.5 The 2009/2010 Capital Programme is to be funded mainly from the Council's capital receipts and government grants. However, following a detailed analysis by the Director of Resources, under delegated powers, the Council funds the Vehicle, Equipment and Systems Renewals with a combination of direct revenue finance and medium term borrowing. This is with the exception of the ICT Strategy for which it is proposed that funding is switched from prudential borrowing to unallocated Capital Receipts as part of this budget process. Several other schemes are also to be funded by direct revenue financing.

4.5.6 Taking the above factors into account, and having regard to the Treasury Management Prudential Indicators and Limits on Activity, the strategy for borrowing is:

1. To fund the capital programme requirements from the Council's own capital receipts, grants, direct revenue funding and borrowing as appropriate.

2. The Vehicle, Equipment and Systems Renewals to be funded by means of medium term borrowing and direct revenue financing with the exception of the ICT Strategy which will be moved to the main Capital Programme and funded from unallocated Capital Receipts subject to approval of the Cabinet Proposal recommending this funding change.

3. To fund any overdrawn bank balances by appropriate borrowing.

4.6 INVESTMENT STRATEGY 2010/11 – 2012/13

4.6.1 The Council's Investment Strategy shall comply with Guidance issued by the CLG and shall have regard to the Code of Practice issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) on Treasury Management in the Public Services: Code of Practice and Cross-Sectional Guidance Notes. The Investment Strategy is set out in Appendix 5.

4.6.2 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. Revised Key Objectives and the introduction of Risk Benchmarking taking into account changes in the Code of Practice are set out below:-

4.6.3 **Key Objectives -** 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 investment 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 tightens the controls already in place in the approved investment strategy.

4.6.4 **Risk Benchmarking** – 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 Appendix 5 Part 2.

4.6.5 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.

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

- 0.05%, this is an upper limit, providing some flexibility for the future, currently; investments are being restricted in accordance with our Investment Strategy.

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

- Bank overdraft – limit of £750,000
- Liquid short term deposits of at least £2m available with a week's notice.
- Weighted Average Life benchmark is expected to be 0.03 years, with a maximum of 0.81 years.

4.6.8 Yield - Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID rate

4.6.9 And in addition that the security benchmark for each individual year is:

	1 year	2 years
Maximum	0.05%	0.05%

Note: This benchmark is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

4.6.10 **Investment Counterparty Selection Criteria –**

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:

- 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.

4.6.11 The Director of Resources will maintain a counterparty list in compliance with the criteria specified in Appendix 6 and will revise the criteria and submit them to Council for approval as necessary. This criteria is separate to that which chooses

Specified and Non-Specified investments as it selects which counterparties the Council will choose rather than defining what its investments are.

Direct investments be made with only those Organisations identified in the ‘Approved Organisations for Investments’ - see Appendix 6.

Individual investment limits to be those identified in Appendix 6.

It should be noted that this criteria is as approved for the July report; it is kept under review but no change is currently deemed necessary.

4.6.12 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.

4.6.13 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 omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. 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.

4.6.14 The proposed criteria for providing a pool of high quality investment counterparties (both Specified and Non-Specified investments) is shown in Annex B1 to Appendix 6 for approval.

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

- For overseas banks, Sovereign rating of AAA;
- no more than 30% will be placed with any individual non-UK country at any time;
- limits in place above will apply to Group companies;
- Sector limits will be monitored regularly for appropriateness.

4.6.16 Use of additional information other than credit ratings – Additional requirements under the Code of Practice now require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties. For organisations with a negative rating watch, the Leader and Chief Executive will continue to have delegated authority to consider inclusion on the approved lending list.

4.6.17 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.

4.6.18 The use of longer term instruments (greater than one year from inception to repayment) will fall in 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 investment prudential indicator detailed in 6.2.1.

4.6.19 Economic Investment Considerations - 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.

4.6.20 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.

4.6.21 The criteria for choosing counterparties set out above provide a sound approach to investment in "normal" market circumstances. Whilst Members are asked to approve this base criteria above, under the exceptional current market conditions the 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.

4.6.22 Examples of these restrictions would be the greater use of the Debt Management Deposit Account Facility (DMADF – a Government body which accepts local authority deposits), Money Market Funds, guaranteed deposit facilities and strongly rated institutions offered support by the UK Government. The credit criteria have been amended to reflect these facilities.

4.6.23 The use of specialist investment managers be considered by the Director of Resources on an ongoing basis, to manage a proportion of the Council's Investments (minimum market requirement usually £10 million) where market conditions are considered favourable to achieve higher overall investment returns. Specialist investment managers will be appointed by the Director of Resources under delegated powers and subject to the Council's Standing Orders Relating to Contracts, if applicable.

4.6.24 Taking the above factors into account, and having regard to the Treasury Management Prudential Indicators and Limits on Activity, the strategy for investments is:

1. To lend funds which are surplus (after cash flow requirements have been taken into account) on a short term basis until the banking system returns to "normal" conditions.

2. Should investment requirements exceed £10million and market conditions are likely to be favourable, to appoint suitable Investment Managers at the

appropriate time in accordance with the Council's Standing Orders Relating to Contracts.

5. SENSITIVITY TO INTEREST RATE MOVEMENTS

5.1 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 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.

£	2010/11 Estimated + 1%	2010/11 Estimated - 1%
Revenue Budgets		
Investment income	150,000	(150,000)

This estimate is based upon the investment returns contained within the Financial Strategy 2010 – 2013.

6. TREASURY MANAGEMENT LIMITS ON ACTIVITY

6.1 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. 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.

6.2.1 The Council is asked to approve the limits:

£m	2010/11	2011/12	2012/13
Interest rate Exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates: • **Debt only** • **Investments only**	100%	100%	100%
Limits on variable interest rates • **Debt only** • **Investments only**	100%	100%	100%
Maximum principal sums invested > 364 days			
Principal sums invested > 364 days	£7m	£4m	£2m
Maturity Structure of fixed interest rate borrowing 2010/11			
		Lower	**Upper**
Under 12 months		0%	100%
12 months to 2 years		0%	100%
2 years to 5 years		0%	100%
5 years to 10 years		0%	100%
10 years and above		0%	100%

7. PERFORMANCE INDICATORS

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

- Investments – Internal returns above the 7 day LIBID rate.

The results of these indicators will be reported in the Treasury Annual Report.

8. TREASURY MANAGEMENT ADVISORS

8.1 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;
- Training and Seminars
- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings/market information service comprising the three main credit rating agencies;

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; the current contract ends on the 31st August 2010 and a competitive procurement exercise will be undertaken to appoint treasury management consultants from September, early in 2010/11.

9. MEMBER AND OFFICER TRAINING

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

- Annual Portfolio holder training from Director of Resources and Treasury Consultants;
- Treasury Management Review Panel annual training updates (with additional updates as necessary);
- Quarterly Treasury Update Reports to Members;
- Daily Officer monitoring of Treasury and Money Market information by Treasury Officers;
- Regular attendance by Officers at professional Seminars provided by Treasury Consultants, CIPFA and CLG:
- Consideration of new qualification, Certificate in International Treasury Management – Public Finance, for Senior Officer

10. LOCAL ISSUES

10.1 The most significant issue to affect the Council relates to the exposure of investments with links to Icelandic Banks. In reacting to this situation the Council established the Treasury Management Review Panel which examined the circumstances leading up to the placing of the particular investments and looking to the future has made recommendations which have been approved by Council in relation to the Council's lending lists.

10.2 During the next year the funds available for investment will reduce as the Council progresses on its Transformation Agenda in areas such as the development of Single Site, the implementation of the ICT Strategy, new arrangements for the collection of recycling, and the provision (in partnership) of a new cemetery and crematorium. Each of the schemes above are being pursued to ensure that the Council can reduce the on-going cost of delivering services.

10.3 Over the coming year the Council is also scheduled to make disposals of assets, however, careful consideration will be made on each opportunity to ensure that the Council sells at a time that maximises the return to the authority.

11. KEY ISSUES

11.1 The Key Issues are contained within sections 4 to 10 of this report, however, there have been a number of changes this year, the most significant are as follows:

- The publication of revised guidance from CIPFA, has required the review of the Council's arrangements. The most significant of which suggests that a group such as the Treasury Management Review Panel be established to scrutinise the Treasury Management Strategy;

- The requirement for the Council to publish the Training arrangements for staff engaged within the Treasury management function and those Members with responsibility for review;
- Consideration of further measures of credit quality to apply to counterparties other than the internationally recognised Credit Rating Agencies;
- The review of Treasury Management Advisors, in respect of Wyre Forest this will see a full tendering exercise in the coming months;

11.2 As reported previously, the returns that the Council is currently receiving from investment returns is significantly lower than those achieved during years up to 2007/08. Although we are forecasting increases in interest rates later this year, increases are expected to be modest and implemented over a long period. Section 5 of this report identifies the on-going sensitivity that the Council faces in relation to investment returns.

12. FINANCIAL IMPLICATIONS

12.1 The Financial Implications of the Treasury management function are included in the Council's Medium Term Financial Strategy and Three Year Budget and Policy Framework.

13. LEGAL AND POLICY IMPLICATIONS

13.1 The Local Government Act 2003 supplemented by Regulations set out a new framework for a prudential system for local authority capital finance. This Act, together with CIPFA's Prudential Code for Capital Finance in Local Authorities, came into effect on 1st April 2004. This code together with recent revised editions, guides decisions on what Local Authorities can afford to borrow and has statutory backing under Regulations issued in accordance with the Local Government Act 2003.

13.2 Adoption of the CIPFA Code of Practice on Treasury Management in the Public Services as part of the Authority's Standing Orders and Financial Regulations, gives it the status of a "code of practice made or approved by or under any enactment", and hence proper practice under the provisions of the Local Government and Housing Act 1989.

14. RISK MANAGEMENT

14.1 The Council is aware of the risks of passive management of the treasury portfolio and, with the support of Butlers, the Council's advisors, has proactively managed the portfolio over the year.

14.2 Shorter-term variable rates and likely future movement in these rates predominantly determine the Council's investment return. These returns can therefore be volatile and, whilst the risk of loss of principal is minimised through the lending list, accurately forecasting returns can be difficult.

14.3 Adoption of the new Butlers Security, Liquidity and Yield Benchmarking tool (Appendix 5 Part 2)

15. EQUALITY IMPACT ASSESSMENT

15.1 This is a financial report and there is no requirement to consider an Equality Impact Assessment.

16. CONCLUSION

See Recommendations.

17. CONSULTEES

Butlers Financial Advisors
Cabinet
Leader of the Council
Corporate Management Team
Treasury Management Review Panel

18. BACKGROUND PAPERS

18.1 Local Government Act 2003
18.2 CIPFA's Revised Prudential Code for Capital Finance in Local Authorities, 2009
18.3 CIPFA's Revised Code of Practice on Treasury Management in the Public Services, 2009
18.4 Local Government and Housing Act 1989
18.5 Cabinet Report 22/09/2009– Report on Treasury Management Service and Actual Prudential Indicators 2008/2009
18.6 Council 25/02/09 – The Prudential System of Local Government Finance and the Treasury Management Policy and Strategy Report 2009/2010
18.7 Cabinet Report 21/07/2009 – Treasury Management Update