**COUNCIL - 16 DECEMBER 2010**

**INVESTMENT STRATEGY 2011/12**

| | |
|---|---|
| Report of the: | Deputy Chief Executive and Director of Corporate Resources |
| Also considered by: | Performance and Governance Committee – 16 November 2010<br>Cabinet - 13 December 2010 |
| Status: | For decision |
| Key Decision: | No |

---

**Executive Summary:** The Local Government Act 2003 (the Act) and supporting regulations requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

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

The Department of Communities and Local Government has issued revised investment guidance which came into effect from 1 April 2010. There were no major changes required over and above the changes already required by the revised CIPFA Treasury Management Code of Practice 2009.

This report differs slightly from that considered by Performance and Governance Committee in order to clarify the wording in paragraph 27, update the forecasts, give the latest position of the investment portfolio and give details of the Prudential Indicators for 2011/12 that were not available previously.

---

This report supports the Key Aim of effective management of Council resources.

**Portfolio Holder** Cllr. Ramsay

**Head of Service** Head of Finance and Human Resources – Mrs. Tricia Marshall

---

**Recommendation:**

That Cabinet recommends Council to approve the Annual Investment Strategy set out in this report.

---

## Background

1 In order to comply with the requirements of the Local Government Act 2003 and supporting regulations, the Council must prepare an Annual Investment Strategy in advance of the forthcoming financial year. The strategy suggested in this report along with the Prudential Indicators relating to the Council's capital investment plans will also be reported to Cabinet for approval.

## Introduction

CIPFA requirements

2 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 23 February 2010.

3 The primary requirements of the Code are as follows:

a) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

b) Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

c) Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a mid-year review report and an annual report (stewardship report) covering activities during the previous year.

d) Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

e) Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Performance and Governance Committee.

Treasury Management Strategy for 2011/12

2 The suggested strategy for 2011/12 in respect of the following aspects of the treasury management function is based upon the treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury adviser, Sector Treasury Services.

3 The strategy covers:

- treasury limits in force which will limit the treasury risk and activities of the Council
- the current treasury position
- Prudential and Treasury Indicators
- prospects for interest rates
- the borrowing strategy
- the Annual Investment Strategy
- creditworthiness policy
- policy on use of external service providers
- the MRP strategy (Appendix A)

Balanced Budget Requirement

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

a) Increases in interest charges caused by increased borrowing to finance additional capital expenditure, and

b) Any increases in running costs from new capital projects are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

**Treasury Limits for 2011/12 to 2013/14**

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

6 The Council must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax levels is ‘acceptable’.

7 Whilst termed an “Affordable Borrowing Limit”, the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive

financial years. Details of the Authorised Limit appear in Appendix C of this report.

## Current Portfolio Position

8 The Council's treasury portfolio position at 25 November 2010 appears in Appendix I.

## Prudential and Treasury Indicators for 2011/12 to 2013/14

9 Prudential Indicators (as set out in Appendix C to this report) are relevant for the purposes of setting an integrated treasury management strategy.

10 The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. This original 2001 Code was adopted on 24 September 2003 by the full Council and the revised Code was adopted on 23 February 2010.

## Prospects for Interest Rates

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

Sector Bank Rate forecast for financial year ends (March)

- 2010/11 0.50%
- 2011/12 1.00%
- 2012/13 2.25%
- 2013/14 3.25%

12 There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected. A detailed view of the current economic background is contained within Appendix D to this report.

## Borrowing Strategy

13 It is anticipated that there will be no capital borrowings required during 2011/12.

## Annual Investment Strategy

Investment Policy

14 The Council will have regard to the CLG's Guidance on Local Government Investments ("the Guidance") issued in March 2004, any revisions to that guidance, the Audit Commission's report on Icelandic investments and the

2009 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities are: -

a) the security of capital; and

b) the liquidity of its investments.

15 The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Council is low in order to give priority to security of its investments.

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

17 Investment instruments identified for use in the financial year are listed in Appendix E under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

Creditworthiness Policy

18 This Council uses the creditworthiness service provided by Sector Treasury Services. This service has been progressively enhanced over the last year and now uses a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moodys and Standard and Poors, forming the core element. However, it does not rely solely on the current credit ratings of counterparties but also uses the following as overlays:-

- credit watches and credit outlooks from credit rating agencies
- Credit Default Swap (CDS) spreads to give early warning of likely changes in credit ratings
- sovereign ratings to select counterparties from only the most creditworthy countries

19 This modelling approach combines credit ratings, credit watches, credit outlooks and CDS spreads in a weighted scoring system for which the end product is a series of colour code bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Council to determine the duration for investments and are therefore referred to as durational bands. The Council is satisfied that this service now gives a much improved level of security for its investments. It is also a service which the Council would not be able to replicate using in house resources.

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

- Purple 2 years

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

21 This Council will not use the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine creditworthy counterparties as Moodys are currently very much more aggressive in giving low ratings than the other two agencies. This would therefore be unworkable and leave the Council with few banks on its approved lending list. The Sector creditworthiness service does though, use ratings from all three agencies, but by using a scoring system, does not give undue preponderance to just one agency's ratings.

22 All credit ratings will be monitored on a weekly basis. The Council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service and a newsflash system exists to alert the Council to any immediate issues arising.

- If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- In addition to the use of Credit Ratings the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Councils lending list.

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

Country Limits

24 The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch Ratings (or equivalent from other agencies if Fitch does not provide) The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix F. This list will be added to or deducted from by officers should ratings change in accordance with this policy.

25 In addition, the Council has previously decided to limit investment to counterparties from the UK and the EU.

Other Creditworthiness Issues

26 As far as building societies are concerned, there is only one that meets the Sector criteria.

27 The Council's current investment policy further limits the one proposed by Sector as follows:-

- Minimum long term credit rating of AA-.
- Maximum investment period of 1 year.
- Total investments in any one foreign country is limited to 15% of the total fund.
- The lower of the following limits applies at the time the investment is placed:-
    - No more than 25% of the total fund to any single institution or institutions within a group of companies.
    - No more than £5m per counterparty excluding call accounts and £6m including call accounts.

Investment Strategy

28 The Council's investment portfolio consists largely of a core balance available for investment over a 2-3 year period or longer, if required, plus cash-flow derived balances. The value of the portfolio at 25 November 2010 is £31.1 million (including £1 million with Landsbanki). Investments will accordingly be made with reference to the core balance and cash-flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

29 **Interest rate outlook**: Bank Rate has been unchanged at 0.50% since March 2009. Bank Rate is forecast to commence rising in quarter 3 of 2010 and then to rise steadily from thereon. Bank Rate forecasts for financial year ends (March) are as follows: -

- 2010/2011 0.50%
- 2011/2012 1.00%
- 2012/2013 2.25%
- 2013/2014 3.25%

30 There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected.

31 The Council will avoid locking into longer term deals while investment rates are down at historically low levels unless attractive rates are available with

counterparties of particularly high creditworthiness which make longer term deals worthwhile and within the risk parameters set by the Council.

32 For 2011/12 it is suggested that the Council should budget for a return of 0.70% on investments of up to three months that are placed during the financial year. Any longer dated investments that might be undertaken will generally attract higher returns and will improve the average figure for the year.

33 It should be noted that the suggested return of 0.70% assumes that Bank Rate starts increasing from November 2011. There is downside risk to this forecast if the start of increases is delayed. If that were to happen, then the suggested return would fall.

34 For its cash flow generated balances, the Council will seek to utilise its call accounts, 15 and 30 day notice accounts and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

End of year investment report

35 At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

Policy on the use of external service providers

36 The Council uses Sector Treasury Services as its external treasury management advisers.

37 The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

38 It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

Scheme of delegation

39 The guidance notes accompanying the revised Code also require that a statement of the Council's scheme of delegation in relation to treasury management is produced as part of the Annual Investment Strategy. This appears at Appendix G.

Role of the Section 151 officer

40 As with the scheme of delegation mentioned in the previous paragraph, a statement of the role of the Section 151 officer is also required. This appears at Appendix H.

## Key Implications

Financial

41 The management of the Council's investment portfolio and cash-flow generated balances plays an important part in the financial planning of the authority. The security of its capital and liquidity of its investments is of paramount importance.

42 There are financial implications arising from the restriction of the Council's lending list in that an inferior rate of interest may have to be accepted on a particular investment if some of the smaller and lower-rated institutions have been removed from the list.

Community Impact and Outcomes

43 There are no community impacts arising from this report.

Legal, Human Rights etc.

44 This report satisfies the requirements of the Local Government Act 2003 and supporting regulations plus the Council's Financial Procedure Rules which both require the preparation of an annual treasury strategy.

## Conclusions

45 The effect of the proposals set out in this report is to allow the Council to effectively and efficiently manage cash balances.

46 In line with the revised CIPFA Code of Practice on Treasury Management, the Annual Treasury Strategy must be considered by Council and this is planned for its meeting on 16 December 2010. Given the current uncertainties in the banking sector and financial markets, the Council may need to consider amending its strategy during the year.

## Risk Assessment Statement

47 Treasury Management has two main risks :

a) Fluctuations in interest rates can result in a reduction in income from investments; and

b) A counterparty to which the Council has lent money fails to repay the loan at the required time.

48 The movement towards having a restricted lending list of better quality institutions but higher individual limits with those institutions reduces the chances of a default. But if a default did occur, the potential loss would be greater. Previously, the preference was to have smaller investments with a greater range of institutions.

49 These risks are mitigated by the annual investment strategy which has been prepared on the basis of achieving the optimum return on investments commensurate with proper levels of security and liquidity. However, Members should recognise that in the current economic climate, these remain significant risks and that the strategy needs to be constantly monitored.

**Sources of Information**:

Existing treasury counterparty list

Treasury Management Strategy Statement for 2011/12 provided by Sector Treasury Services Ltd.

CIPFA – Prudential Code on Treasury Management

ODPM (now DCLG) – Guidance on Local Government Investments (March 2004)

CIPFA Treasury Management in the Public Services Code of Practice (Revised 2009)

**Contact Officer(s):** Roy Parsons ext.7204

**Dr. Pav Ramewal**
**Deputy Chief Executive and Director of Corporate Resources**

## Minimum Revenue Provision – an introduction

### 1. What is a Minimum Revenue Provision?

Capital expenditure is generally expenditure on assets which have a life expectancy of more than one year e.g. buildings, vehicles, machinery etc. It would be impractical to charge the entirety of such expenditure to revenue in the year in which it was incurred therefore such expenditure is spread over several years in order to try to match the years over which such assets benefit the local community through their useful life. The manner of spreading these costs is through an annual Minimum Revenue Provision, which was previously determined under Regulation, and will in future be determined under Guidance.

### 2. Statutory duty

Statutory Instrument 2008 no. 414 s4 lays down that:

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

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

There is no requirement to charge MRP where the Capital Financing Requirement is nil or negative at the end of the preceding financial year.

The share of Housing Revenue Account CFR is not subject to an MRP charge.

### 3. Government Guidance

Along with the above duty, the Government issued new guidance which came into force on 31 March 2008 which requires that a Statement on the Council's policy for its annual MRP should be submitted to the full Council for approval before the start of the financial year to which the provision will relate.

The Council is legally obliged to "have regard" to the guidance, which is intended to enable a more flexible approach to assessing the amount of annual provision than was required under the previous statutory requirements. The guidance offers four main options under which MRP could be made, with an overriding recommendation that the Council should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits. The requirement to 'have regard' to the guidance therefore means that: -

1. Although four main options are recommended in the guidance, there is no intention to be prescriptive by making these the only methods of charge under which a local authority may consider its MRP to be prudent.

2. It is the responsibility of each authority to decide upon the most appropriate method of making a prudent provision, after having had regard to the guidance.

**Option 1: Regulatory Method**

Under the previous MRP regulations, MRP was set at a uniform rate of 4% of the adjusted CFR (i.e. adjusted for "Adjustment A") on a reducing balance method (which in effect meant that MRP charges would stretch into infinity). This historic approach must continue for all capital expenditure incurred in years before the start of this new approach. It may also be used for new capital expenditure up to the amount which is deemed to be supported through the SCE annual allocation.

**Option 2: Capital Financing Requirement Method**

This is a variation on option 1 which is based upon a charge of 4% of the aggregate CFR without any adjustment for Adjustment A, or certain other factors which were brought into account under the previous statutory MRP calculation. The CFR is the measure of an authority's outstanding debt liability as depicted by their balance sheet.

**Option 3: Asset Life Method.**

This method may be applied to most new capital expenditure, including where desired that which may alternatively continue to be treated under options 1 or 2.

Under this option, it is intended that MRP should be spread over the estimated useful life of either an asset created, or other purpose of the expenditure. There are two useful advantages of this option: -

- Longer life assets e.g. freehold land can be charged over a longer period than would arise under options 1 and 2.
- No MRP charges need to be made until the financial year after that in which an item of capital expenditure is fully incurred and, in the case of a new asset, comes into service use (this is often referred to as being an 'MRP holiday'). This is not available under options 1 and 2.

There are two methods of calculating charges under option 3:

a. equal instalment method – equal annual instalments,

b. annuity method – annual payments gradually increase during the life of the asset.

**Option 4: Depreciation Method**

Under this option, MRP charges are to be linked to the useful life of each type of asset using the standard accounting rules for depreciation (but with some exceptions) i.e. this is a more complex approach than option 3.

The same conditions apply regarding the date of completion of the new expenditure as apply under option 3.

### 4. Date of implementation

The previous statutory MRP requirements ceased to have effect after the 2006/07 financial year. Transitional arrangements included within the guidance no longer apply for the MRP charge for 2009/10 onwards. Therefore, options 1 and 2 should only be used for Supported Capital Expenditure (SCE). However, it should be remembered that the above is guidance only and authorities may consider alternative individual MRP approaches, as long as they are consistent with the statutory duty to make a prudent revenue provision.

### Minimum Revenue Provision Policy Statement 2010/11

The Council implemented the new Minimum Revenue Provision (MRP) guidance in 2009/10, and will assess its MRP for 2011/12 in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

As the Council's Capital Financing Requirement is nil or negative, there will be no requirement to charge MRP in 2011/12.

## INTEREST RATE FORECASTS

The data below shows a variety of forecasts published by a number of institutions. The first three are individual forecasts including those of UBS and Capital Economics (an independent forecasting consultancy). The final one represents summarised figures drawn from the population of all major City banks and academic institutions.

The forecast within this strategy statement has been drawn from these diverse sources and officers' own views.

## 1. INDIVIDUAL FORECASTS

**Sector** interest rate forecast – 12.11.10

| | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 | Mar-12 | Jun-12 | Sep-12 | Dec-12 | Mar-13 | Jun-13 | Sep-13 | Dec-13 | Mar-14 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Bank rate | 0.50% | 0.50% | 0.50% | 0.50% | 0.75% | 1.00% | 1.25% | 1.50% | 1.75% | 2.25% | 2.75% | 3.00% | 3.25% | 3.25% |
| 5yr PWLB rate | 3.00% | 3.00% | 3.10% | 3.20% | 3.30% | 3.50% | 3.80% | 4.10% | 4.30% | 4.40% | 4.50% | 4.70% | 4.90% | 5.00% |
| 10yr PWLB rate | 4.10% | 4.10% | 4.10% | 4.20% | 4.30% | 4.40% | 4.60% | 4.80% | 4.90% | 5.00% | 5.10% | 5.20% | 5.30% | 5.40% |
| 25yr PWLB rate | 5.00% | 5.10% | 5.20% | 5.30% | 5.30% | 5.40% | 5.40% | 5.40% | 5.50% | 5.50% | 5.50% | 5.60% | 5.70% | 5.70% |
| 50yr PWLB rate | 5.10% | 5.20% | 5.30% | 5.40% | 5.40% | 5.50% | 5.50% | 5.50% | 5.60% | 5.60% | 5.60% | 5.60% | 5.70% | 5.70% |

**Capital Economics** interest rate forecast – 8.11.10

| | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 | Mar-12 | Jun-12 |
|---|---|---|---|---|---|---|---|
| Bank Rate | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% |
| 5yr PWLB rate | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% | 2.50% |
| 10yr PWLB rate | 3.75% | 3.75% | 3.75% | 3.75% | 3.75% | 3.75% | 3.75% |
| 25yr PWLB rate | 4.80% | 4.80% | 4.80% | 4.80% | 4.80% | 4.80% | 4.80% |
| 50yr PWLB rate | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% |

**UBS** interest rate forecast (for quarter ends) – 20.10.10

| | Dec-10 | Mar-11 | Jun-11 | Sep-11 | Dec-11 |
|---|---|---|---|---|---|
| Bank rate | 0.50% | 0.50% | 0.50% | 0.75% | 1.00% |
| 10yr PWLB rate | 4.00% | 4.10% | 4.30% | 4.50% | 4.60% |
| 25yr PWLB rate | 5.10% | 5.10% | 5.10% | 5.20% | 5.30% |
| 50yr PWLB rate | 5.10% | 5.20% | 5.20% | 5.30% | 5.40% |

## 2. SURVEY OF ECONOMIC FORECASTS

### HM Treasury October 2010

The current Q4 2010 and 2011 forecasts are based on the October 2010 report. Forecasts for 2010 – 2014 are based on 32 forecasts in the last quarterly forecast – in August 2010.

| BANK RATE FORECASTS | Bank Rate | Quarter end | | Annual ave. Bank Rate | | | | |
|---|---|---|---|---|---|---|---|---|
| | actual | Q4 2010 | Q4 2011 | ave. 2010 | ave. 2011 | ave. 2012 | ave. 2013 | ave. 2014 |
| Median | 0.50% | 0.50% | 0.90% | 0.50% | 1.00% | 1.90% | 2.80% | 3.40% |
| Highest | 0.50% | 0.80% | 3.20% | 0.60% | 2.10% | 3.10% | 4.10% | 5.30% |
| Lowest | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 1.20% |

## PRUDENTIAL INDICATORS

| PRUDENTIAL INDICATOR | 2009/10 | 2010/11 | 2011/12 | 2012/13 | 2013/14 |
|---|---|---|---|---|---|
| **(1). EXTRACT FROM BUDGET SETTING REPORT** | **£'000** | **£'000** | **£'000** | **£'000** | **£'000** |
| | **actual** | **probable outturn** | **estimate** | **estimate** | **estimate** |
| **Capital Expenditure** | 1,381 | 1,921 | 1,043 | 1,027 | 1,027 |
| **Ratio of financing costs to net revenue stream** | -4% | -1% | -1% | -2% | -4$ |
| **Net borrowing requirement** | | | | | |
| brought forward 1 April | 0 | 0 | 0 | 0 | 0 |
| carried forward 31 March | 0 | 0 | 0 | 0 | 0 |
| in year borrowing requirement | 0 | 0 | 0 | 0 | 0 |
| **Capital Financing Requirement as at 31 March** | 0 | 0 | 0 | 0 | 0 |
| **Annual change in Cap. Financing Requirement** | 0 | 0 | 0 | 0 | 0 |
| **Incremental impact of capital investment decisions** | **£ p** | **£ p** | **£ p** | **£ p** | **£ p** |
| Increase in council tax (band D) per annum | 0.00 | 0.00 | -0.14 | -0.16 | -0.16 |

| PRUDENTIAL INDICATOR | 2009/10 | 2010/11 | 2011/12 | 2012/13 | 2013/14 |
|---|---|---|---|---|---|
| (2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS | £'000 | £'000 | £'000 | £'000 | £'000 |
| | actual | probable outturn | estimate | estimate | estimate |
| **Authorised Limit for external debt -** | | | | | |
| borrowing | £5,000 | £5,000 | £5,000 | £5,000 | £5,000 |
| other long term liabilities | £0 | £0 | £0 | £0 | £0 |
| TOTAL | £5,000 | £5,000 | £5,000 | £5,000 | £5,000 |
| **Operational Boundary for external debt -** | | | | | |
| borrowing | £0 | £0 | £0 | £0 | £0 |
| other long term liabilities | £0 | £0 | £0 | £0 | £0 |
| TOTAL | £0 | £0 | £0 | £0 | £0 |
| **Upper limit for fixed interest rate exposure** | | | | | |
| Net principal re fixed rate borrowing / investments | 100% | 100% | 100% | 100% | 100% |
| **Upper limit for variable rate exposure** | | | | | |
| Net principal re variable rate borrowing / investments | 50% | 50% | 50% | 50% | 50% |
| **Upper limit for total principal sums invested for over 364 days** | £15,000 | £10,000 | £10,000 | £10,000 | £10,000 |

| **Maturity structure of fixed rate borrowing during 2011/12** | upper limit | lower limit |
|---|---|---|
| under 12 months | 0% | 0% |
| 12 months and within 24 months | 0% | 0% |
| 24 months and within 5 years | 0% | 0% |
| 5 years and within 10 years | 0% | 0% |
| 10 years and above | 0% | 0% |

**Item No. 5(c) - Appendix C**

## ECONOMIC BACKGROUND (PROVIDED BY SECTOR, AS AT 12.11.10)

### 1. Global economy

The sovereign debt crisis peaked in May 2010 prompted, in the first place, by major concerns over the size of the Greek government's total debt and annual deficit. However, any default or write down of Greek debt would have substantial impact on other countries, in particular, Portugal, Spain and Ireland. This crisis culminated in the EU and IMF putting together a €750bn support package in mid May. A second crisis, this time over Ireland, is currently in progress as at November 2010.

The unexpectedly high rate of growth in quarters 2 and 3 of 2010 in the UK and in quarter 2 of 2010 in the Euro zone were driven by strong growth in the construction sector catching up from inclement weather earlier in the year and by other short term factors not expected to be enduring; general expectations are for anaemic (but not negative) growth in 2011 in the western world.

### 2. UK economy

Following the general election in May 2010, the coalition government has put in place an austerity plan to carry out correction of the public sector deficit over the next five years. The inevitable result of fiscal contraction will be major job losses during this period, in particular in public sector services. This will have a knock on effect on consumer and business confidence and appears to have also hit the housing market as house prices have started on a negative trend during the summer and autumn of 2010. Mortgage approvals are also at very weak levels and declining, all of which indicates that the housing market is likely to be very weak next year.

**Economic Growth** – GDP growth is likely to have peaked in the current period of recovery at 1.2% in quarter 2 of 2010. The first estimate of +0.8% for quarter 3 was also unexpectedly high. However, the outlook is for anaemic growth in 2011/12 although the Bank of England and the Office for Budget Responsibility are forecasting near trend growth of 2.5% (i.e. above what most forecasters are currently expecting).

**Unemployment** – the trend of falling unemployment (on the benefit claimant count) has now been replaced since July 2010 with small increases which are likely to be the start of a new trend for some years ahead of rising unemployment.

**Inflation and Bank Rate** – CPI has remained high during 2010. It peaked at 3.7% in April and has gradually declined to 3.1% in September (RPI 4.6%). Although inflation has remained stubbornly above the Bank of England's Monetary Policy Committee (MPC) 2% target, the MPC is confident that inflation will fall back under the target over the next two years after another rise back up to about 3.5% by the end of 2010.

The Bank of England finished its programme of quantitative easing (QE) with a total of £200bn in November 2009. However, a major expectation that there could be a second round of QE in late 2010 or early 2011, to help support economic growth, evaporated after the surprise of the Q3 GDP figure of +0.8% and the November Inflation Report revising the forecast for short term inflation sharply upwards.

Sector's view is that there is unlikely to be any increase in Bank Rate until the end of 2011.

**AAA rating** – prior to the general election, credit rating agencies had been issuing repeated warnings that unless there was a major fiscal contraction, then the AAA sovereign rating was at significant risk of being downgraded. Sterling was also under major pressure during the first half of the year. However, after the Chancellor's budget on 22 June, Sterling strengthened against the US dollar and confidence has returned that the UK will retain its AAA rating. In addition, international investors now view UK government gilts as being a safe haven from EU government debt. The consequent increase in demand for gilts helped to add downward pressure on gilt yields and PWLB rates.

## 3. Sector's forward view

It is currently difficult to have confidence as to exactly how strong the UK economic recovery is likely to be, and there are a range of views in the market. Sector has adopted a moderate view. There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas:

- the speed of economic recovery in our major trading partners - the US and EU
- the danger of currency war and resort to protectionism and tariff barriers if China does not address the issue of its huge trade surplus due to its undervalued currency
- the degree to which government austerity programmes will dampen economic growth and undermine consumer confidence
- changes in the consumer savings ratio
- the speed of rebalancing of the UK economy towards exporting and substituting imports
- the potential for more quantitative easing, and the timing of this in both the UK and US, and its subsequent reversal
- the speed of recovery of banks' profitability and balance sheet imbalances and the consequent implications for the availability of credit to borrowers
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy

The overall balance of risks is weighted to the downside and there is some risk of a double dip recession and deleveraging, creating a downward spiral of falling demand, falling jobs and falling prices, although this is currently viewed as being a small risk.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

**SPECIFIED AND NON-SPECIFIED INVESTMENTS**

## 1. Specified Investments

All such investments will be sterling denominated, with maturities up to a maximum of one year, meeting the minimum 'high' rating criteria where applicable.

| | **Minimum 'High' Credit Criteria** | **Maximum maturity period** |
|---|---|---|
| Debt Management Agency Deposit Facility | - | 6 months |
| Term deposits – other LA's | - | 1 year |
| Term deposits - banks | Long term AA- or better, plus Sector colour code 'Green' or better | 1 year |
| Term deposits – building societies | Long term AA- or better, plus Sector colour code 'Green' or better | 1 year |

Since the credit crunch there have been a number of developments which require separate consideration and approval for use:

- **Nationalised banks** in the UK have credit ratings which do not conform to the credit criteria usually used by local authorities to identify banks which are of high credit worthiness. In particular, as they no longer are separate institutions in their own right, it is impossible for Fitch to assign them an individual rating for their stand alone financial strength. Accordingly, Fitch have assigned an F rating which means that at a historical point of time, this bank failed and is now owned by the Government. However, these institutions are now recipients of an F1+ short term rating as they effectively take on the creditworthiness of the Government itself i.e. deposits made with them are effectively being made to the Government. They also have a support rating of 1; in other words, on both counts, they have the highest ratings possible.

- **Blanket (explicit) guarantees on all deposits**. Some countries have supported their banking system by giving a blanket guarantee on ALL deposits e.g. Ireland and Singapore. Authorities may view that the sovereign rating of that country then takes precedence over the individual credit ratings for the banks covered by that guarantee. Authorities need to decide if they wish to rely on these blanket guarantees to authorise lending to banks covered by these guarantees and for which countries they are prepared to do so.

- **UK banking system support package (implicit guarantee)**. It should be noted that the UK Government has NOT given a blanket guarantee on all deposits but has underlined its determination to ensure the security of the UK banking system by supporting eight named banks with a £500bn support package. Again, authorities need to decide if they wish to authorise lending to those named banks on the basis of that implicit guarantee on local authority deposits placed with these eight banks or to rely on the credit ratings of the individual banks.

- **Other countries**. Authorities will also need to decide if they wish to rely on this implicit guarantee for the banking systems of other countries. The US, countries within the EU and Switzerland (and other countries) are currently providing major support packages to their banking systems.

At its meeting in December 2008, Cabinet decided only to lend to UK and EU institutions.

| | **Minimum Credit Criteria** | **Maximum Maturity Period** |
|---|---|---|
| UK nationalised banks | Sector colour code 'Blue' | 1 year |
| Banks nationalised by high credit rated (sovereign rating) countries – non UK | Sovereign rating AA- or better, plus long term rating AA- or better, plus Sector colour code 'Green' or better | 1 year |
| Non UK banks with Government guarantee (explicit) on ALL deposits by high credit rated (sovereign rating) countries | Sovereign rating AA- or better, plus long term rating AA- or better, plus Sector colour code 'Green' or better | 1 year |
| UK Government support to the banking sector (implicit guarantee) * | UK Sovereign rating AA- or better, plus long term rating AA- or better, plus Sector colour code 'Green' or better | 1 year |

* The original list of banks covered when the support package was initially announced was:

- Abbey (now part of Santander)
- Barclays
- HBOS (now part of the Lloyds group)
- Lloyds TSB
- HSBC
- Nationwide Building Society

- RBS
- Standard Chartered

Banks eligible for support under the UK bail-out package and which have issued debt guaranteed by the Government are eligible for a continuing Government guarantee when debt issues originally issued and guaranteed by the Government mature and are refinanced. However, no other institutions can make use of this support as it closed to new issues and entrants on 28.2.10. The banks which have used this explicit guarantee are as follows: -

- Bank of Scotland
- Barclays
- Clydesdale
- Coventry Building Society
- Investec bank
- Nationwide Building Society
- Rothschild Continuation Finance plc
- Standard Life Bank
- Tesco Personal Finance plc
- Royal Bank of Scotland
- West Bromwich Building Society
- Yorkshire Building Society

The following categories of investment may have variable interest rates and/or variable maturity dates.

| | **Minimum Credit Criteria** | **Maximum Maturity Period** |
|---|---|---|
| Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee | UK Sovereign rating AA- or better, plus long term rating AA- or better, plus Sector colour code ‘Green’ or better | 1 year |
| Certificates of deposit issued by banks and building societies covered by the UK Government banking support package (implicit guarantee) | UK Sovereign rating AA- or better, plus long term rating AA- or better, plus Sector colour code ‘Green’ or better | 1 year |
| Certificates of deposit issued by banks and building societies NOT covered by UK Government support package (implicit guarantee) | UK Sovereign rating AA- or better, plus long term rating AA- or better, plus Sector colour code ‘Green’ or better | 1 year |

| | | |
|---|---|---|
| UK Government gilts | UK Sovereign rating AA- or better | 1 year |
| Bonds issued by multilateral development banks | Long-term rating AAA | 1 year |
| Bonds issuance by a financial institution which is explicitly guaranteed by the UK Government (refers solely to GEFCO – Guaranteed Export Finance Corporation) | UK Sovereign rating AA- or better | 1 year |
| Sovereign bond issues (i.e. other than UK Government | Long-term rating AAA | 1 year |
| Treasury bills | UK Sovereign rating AA- or better | 3 months |
| Money Market Funds | Long-term rating AAA | 1 year |

## 2. Non-Specified Investments

As the Council has a maximum investment period of one year, many investments previously listed in this category are no longer applicable.

| | **Minimum Credit Criteria** | **Max % of total invested** | **Max. Maturity Period** |
|---|---|---|---|
| Fixed term deposits with variable rate and variable maturities (i.e. structured deposits) | Sovereign rating AA- or better, plus long term rating AA- or better, plus Sector colour code 'Green' or better | 25 | 1 year |

A maximum of 25% will be held in aggregate in non-specified investments.

## APPROVED COUNTRIES FOR INVESTMENTS

AAA

- Canada
- Denmark
- Finland
- France
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland
- U.K.
- U.S.A.

AA+

- Australia
- Belgium
- Spain *

AA

- Hong Kong
- Japan
- Kuwait
- Qatar
- UAE

AA-

- Italy
- Portugal *
- Saudi Arabia

** Sector has suggested that care and caution be exercised when considering placing deposits with Portuguese and Spanish banks as their economies are currently under severe pressure.*

*Ireland no longer appears on this list as it has been downgraded to A+.*

**TREASURY MANAGEMENT SCHEME OF DELEGATION**

Council

- receiving and reviewing reports on treasury management policies, practices and activities
- approval of annual strategy

Cabinet

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices
- budget consideration and approval
- approval of the division of responsibilities
- receiving and reviewing regular monitoring reports and acting on recommendations
- approving the selection of external service providers and agreeing terms of appointment

Performance and Governance Committee

- reviewing the treasury management policy and procedures and making recommendations to the Cabinet

**THE TREASURY MANAGEMENT ROLE OF THE SECTION 151 OFFICER**

The Section 151 Officer is responsible for:-

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