

Treasury Management Strategy Statement and Annual Investment Strategy for 2010/2011

Introduction

1. The Local Government Act 2003 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.
2. 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). The Annual Investment Strategy sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.
3. The proposed strategy for 2010/11 in respect of the following aspects of the treasury management function is based upon the views of the Council's Treasury Management Strategy Team (TMST)¹, informed by market forecasts provided by the Council's treasury advisor, Arlingclose Limited. The strategy covers:
 - Treasury limits in force which limit the treasury risk and activities of the Council;
 - Prudential Indicators;
 - the current treasury position;
 - prospects for interest rates;
 - the borrowing strategy;
 - the borrowing requirement;
 - the investment strategy;
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 caused by increased borrowing to finance additional capital expenditure, and 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.

¹ Comprising the Assistant Chief Executive & Chief Finance Officer, Head of Finance & Procurement, Assistant Head of Finance (Corporate Finance), Principal Financial Manager – Treasury & Pension Fund Investments and Financial Manager – Treasury & Pension Fund Investments

5. The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. The code was adopted by Council on 1 April 2003.
6. Given the turmoil in the banking sector in the last 18 months, on 4 November 2008 Council agreed that any changes to the Strategy may be delegated to the Chief Finance Officer in consultation with the Cabinet Member for Finance and leaders of the Opposition and other groups. Any changes to the Strategy will be reported to Cabinet and Council at the meetings subsequent to any changes. It is proposed that the ongoing recommendation is changed to reflect the new composition of Council, and that consultation is with the Cabinet Member for Finance and leaders of the Opposition and the Labour group.

Treasury Limits for 2010/11 to 2012/13

7. It is a statutory duty under Section 3 of the Local Government Act 2003 and supporting regulations, for the Council to determine and keep under review the amount it can afford to borrow. This amount is termed the 'Affordable Borrowing Limit'. In England and Wales the Authorised Limit represents the legislative limit specified in section 3 of the Local Government Act 2003.
8. The Council must have regard to the Prudential Code when setting the 'Authorised Borrowing Limit'. The Authorised Limit, essentially requires the Council to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon future council tax levels is 'acceptable'.
9. 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.

Prudential Indicators for 2010/11 to 2012/13

10. The Prudential Indicators set out below are part of the integrated treasury management strategy.
11. It is recommended that Council approves the authorised limits for total external debt gross of investments for the next three financial years.

| PRUDENTIAL INDICATOR | 2009/10 | 2010/11 | 2011/12 | 2012/13 |
|--|-------------------------|-----------------|-----------------|-----------------|
| (2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS | £'000 | £'000 | £'000 | £'000 |
| | probable outturn | estimate | estimate | estimate |
| Authorised Limit for external debt - borrowing | £510m | £534m | £530m | £550m |
| other long term liabilities | £5m | £5m | £5m | £5m |
| TOTAL | £515m | £539m | £535m | £565m |
| Operational Boundary for external debt - borrowing | £500m | £524m | £520m | £550m |
| other long term liabilities | £5m | £5m | £5m | £5m |
| TOTAL | £505m | £529m | £525m | £555m |
| Upper limit for fixed interest rate exposure expressed as: Net principal re fixed rate borrowing / investments | 150% | 150% | 150% | 150% |
| Upper limit for variable rate exposure expressed as: Net principal re variable rate borrowing / investments | 25% | 25% | 25% | 25% |
| Upper limit for total principal sums invested for over 364 days | £100m | £100m | £100m | £100m |

| Maturity structure of fixed rate borrowing during 2010/11 | Lower Limit % | Upper Limit % |
|--|----------------------|----------------------|
| Under 12 months | 0 | 20 |
| 12 months and within 24 months | 0 | 25 |
| 24 months and within 5 years | 0 | 35 |
| 5 years and within 10 years | 5 | 40 |
| 10 years and above | 50 | 95 |

Current Portfolio Position

12. The Council's treasury portfolio position for the 2009/10 financial year up to and at 30 November 2009 comprised:

| | Principal £m | Average Rate % |
|------------------------------------|-------------------------|---------------------------|
| Debt | | |
| PWLB | 352.383 | 4.95% |
| Money Market Loans | 50.000 | 3.76% |
| Other Long-Term Liabilities | 5.056 | |
| TOTAL EXTERNAL DEBT | 407.439 | |
| Investments | | |
| Average Monthly Cash Balance | | |
| Average Monthly Externally Managed | 201.404 | 1.10% |
| | 23.710 | 3.09% |
| TOTAL INVESTMENTS | 225.114 | |

Prospects for Interest Rates

Current Medium Term Financial Plan

13. The strategy for 2009/10 approved by Council in February 2009 set out forecast interest rates over the medium term. The forecast was for an average base rate of 0.5% in 2009/10, 1.00% in 2010/11, 1.50% in 2011/12, 2.10% in 2012/13 and 2.75% in 2013/14. These interest rates were used as a basis for constructing the strategic measures budget for 2009/10 to 2013/14.

Arlingclose's View

14. The Council has appointed Arlingclose Limited to provide investment advice to the Council, as part of this service they help the Council to formulate a view on interest rates. Annex 8b of the Service & Resource Planning report to Cabinet in January 2010 draws together a number of City forecasts for short term (Bank Rate) and longer term fixed interest rates.
15. Arlingclose's current view on interest rates is that the Bank Rate:
- Will remain at 0.5% until November 2010
 - Will gradually increase from December 2010 to March 2011 to 1.50%
 - Will rapidly increase to 4.00% by December 2011 and remain there for the rest of the financial year.
16. There is a downside risk to these forecasts if the economy could not sustain such a rapid increase in interest rates. There is also an upside risk that the Bank of England's Monetary Policy Committee may begin the process of base rate increases earlier than forecast.

- Arlingclose are of the view that short term money market rates are likely to remain at very low levels, although they have not quantified what spreads over Base Rate to expect.

Treasury Strategy Management Team's View

17. The Council's TMST, taking into account the advice from Arlingclose, and the current economic outlook, have determined the rates to be included in the Strategic Measures budget for 2010/11 and over the medium term. The Bank Rate forecasts set out below represent the average rate for the financial year:

- 2010/11 0.63%
- 2011/12 1.75%
- 2012/13 2.63%
- 2013/14 2.75%
- 2014/15 3.50%

18. It is the view of the team that as rates achieved on deposits in the past have been over and above that of the Bank Rate that a return rate should also be budgeted for. The team has agreed that the return rate should be 0.60% higher than the average Bank Rate for each year over the medium term. The rate this gives is set out below. These rates have been incorporated into the strategic measures budget estimates:

- 2010/11 1.23%
- 2011/12 2.35%
- 2012/13 3.23%
- 2013/14 3.35%
- 2014/15 4.10%

Borrowing Strategy

Arlingclose's View

19. Arlingclose's forecasts have an upside risk of between 25 and 50 basis points, and a downside risk of 25 basis points depending on the economic and political climate.
20. Arlingclose's forecasts for the Public Works Loan Board (PWLB) new borrowing rates are as follows:
- The 50 year PWLB rate is expected to start the financial year at 4.25%, increasing to 4.50% in June 2010. A further increase is forecast to 4.75% by December 2010, remaining at that level for the rest of the forecast period.
 - The 25 year PWLB rate is expected to start the financial year at 4.25% rising to 4.50% in June, 4.75% in September and 5.00% in December 2010, remaining at that level for the rest of the forecast period.

- The 10 year PWLB rate is expected to start the financial year at 3.75%, rising to 4.00% in June and again to 4.25% in March 2011. Further increases are forecast with the rate ending at 4.75% in March 2012.
- The 5 year PWLB rate is expected to start the financial year at 2.70% with gradual quarterly increases forecast to reach 3.25% by March 2011. Further gradual increases are forecast until the rate reaches 4.25% by March 2012.

21. This forecast indicates, therefore, that there is a range of options available when setting a borrowing strategy for 2010/11. Short dated gilt yields are forecast to be lower than medium and long dated gilt yields during the financial year. Despite additional gilt issuance by the UK Government, short dated gilts are expected to benefit from expectation of lower interest rates as the economy struggles. Variable rates are expected to remain low as the Bank Rate is maintained at historically low levels.

Treasury Strategy Management Team's View

22. It is the view of the Council's TSMT that the outcome of the 2010 General Election, any possible change in the UK's Sovereign credit rating (currently on negative outlook with Standard & Poors), and the effect of the reversal of the recent Quantitative Easing could cause gilts yields, and therefore PWLB borrowing rates to rise in 2010 and beyond.
23. 2010/11 is expected to be a time of continued low Bank Rate. Therefore the "cost of carry" associated with the long term borrowing compared to temporary investment returns means that the appetite for new long term borrowing brings with it additional short term costs. Financing the Council's borrowing requirement internally would reduce the "cost of carry" in the short term, however this must be weighed against the possibility of refinancing any internal borrowing at a time when PWLB rates far exceed those currently available.
24. The Council's TSMT therefore have agreed that they should continue to have the option to fund new or replacement borrowing up to the value of 25% of the portfolio (currently approximately £50m) through internal borrowing. It is likely that a combination of internal and external borrowing will be used to fund the financing requirement. This will have the effect of reducing some of the "cost of carry" of funding, and also aiding the Council to retain the ability of financing the borrowing requirement through internal balances at a time in the future when borrowing rates may be prohibitively expensive.
25. If the market conditions change during the 2010/11 financial year such that the policy to borrow internally is no longer in the interests of the authority, the TSMT will review the borrowing strategy and report any changes to Cabinet.
26. The team's forecast for PWLB rates over the medium term are set out below. These rates have been incorporated into the strategic measures budget estimates:

- 2010/11 4.00%
- 2011/12 4.50%
- 2012/13 4.50%
- 2013/14 4.50%

LOBOs (Lender's option/Borrower's option)

27. The Council has set a maximum limit of 20% of the debt portfolio to be borrowed in the form of LOBOs. It is recommended that this remain as the limit for 2010/11. As at 30 November 2009, LOBOs represent 13.14% of the total external debt.
28. The Council has three £5m LOBO's with call options in 2010/11. The first has call options in April 2010 and October 2010, the next with call options in May 2010 and the last in November 2010. If the lender chooses to increase the current rate of interest payable, the Council will evaluate alternative financing options before deciding whether or not to accept the new rate offered.

Borrowing Requirement

29. In order to finance the Capital Programme the Council's long-term debt is projected to increase from £431.417m in April 2010 to £445.190m by 31 March 2011, part of which may be funded internally.

| | 2009/10 £m Probable | 2010/11 £m Estimate | 2011/12 £m Estimate | 2012/13 £m Estimate |
|----------------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| Net New Borrowing – Internal | 14.337 | 0.573 | 7.000 | |
| Net New Borrowing – External | 8.000 | 14.000 | 11.001 | 16.291 |
| Replacement Borrowing - Internal | | 15.000* | 10.000* | |
| Replacement Borrowing - External | 12.000 | 6.000 | 11.000 | 16.000* |
| TOTAL | 34.337 | 35.573 | 39.001 | 32.291 |

*replacement borrowing in 2010/11 includes three £5m potential repayment of LOBO loans. In 2011/12 the replacement borrowing figure includes two £5m potential LOBO loan repayments. A further two £5m LOBO loan repayments could potentially be called in 2012/13.

Annual Investment Strategy

30. The Council has regard to the Office of the Deputy Prime Minister's Guidance on Local Government Investments ("the Guidance") issued in March 2004 and CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). Communities and Local

Government (formerly ODPM) have issued a consultation paper on changes to the Investment Guidance, Capital Finance Regulations and Minimum Revenue Provision Guidance. Any changes in the revised guidance will come into force on 1st April 2010 and are reflected in this report. The Council's investment priorities are:-

- (a) The security of capital and
- (b) The liquidity of its investments

31. The Council also aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The borrowing of monies purely to invest or on-lend and make a return is unlawful and the Council will not engage in such activity.
32. Investment instruments identified for use in the financial year are listed below under the 'Specified' and 'Non-Specified' Investment categories. Guidance states that specified investments are those requiring "minimal procedural formalities". The placing of cash on deposit with banks and building societies 'awarded high credit ratings by a credit rating agency' and investments with the UK Government and local authorities qualify as falling under this phrase as they form a normal and minimum part of day to day treasury management.
33. Non specified investment products are those which take on greater risk. They are subject to greater scrutiny and should therefore be subject to more rigorous justification and agreement of their use in the Annual Investment Strategy; this applies regardless of whether they are under one year investments and have high credit ratings.
34. The Council uses Fitch ratings as the basis by which to set its minimum credit criteria for deposits and derive its counterparty limits. The TMST may further limit these by using other available information such as Credit Default Swap Rates, Shareprices, Ratings Watch & Outlook notices. Counterparty limits and maturity limits are derived from the credit rating matrix as set out in the tables at paragraphs 42 and 43 respectively. The Council may also use alternative credit rating agencies such as Standard & Poors and Moodys, in these instances the equivalent ratings will apply.
35. Notification of any rating changes (or ratings watch and outlook notifications) by Fitch are monitored daily by a member of the Treasury Management Team. Rating changes by other credit rating agencies are reported to the TMST by Arlingclose.
36. Where a change in credit rating places a counterparty on the approved lending list outside the credit matrix (as set out in tables 42 and 43), that counterparty will be immediately removed from the lending list.
37. Where a counterparty has been placed on Negative Watch or Outlook by a credit rating agency, the counterparty will be immediately suspended from the approved lending list. The TMST will then consider the notification and any

other information as described in paragraph 35 before deciding whether the counterparty should be reinstated or removed from the approved lending list.

38. In addition, the TSMT apply further limits, to mitigate risk by diversification. These include:
- Limiting the amount lent to banks in any one country (excluding the UK) to a maximum of 20% of the investment portfolio.
 - Limiting the amount lent to any bank, or banks within the same group structure to 10% of the investment portfolio.
39. Any changes to the approved lending list will continue to be reported to Cabinet as part of the monthly Financial Monitoring Report.

Specified Investments

40. All such investments will be sterling denominated, with maturities up to a maximum of 1 year, meeting the 'high' credit rating criteria where applicable.

| Investment Instrument | Minimum Credit Criteria | Use |
|--|---|----------------------------|
| Debt Management Agency Deposit Facility | N/A | In-house and Fund Managers |
| Term Deposits – UK Government | N/A | In-house |
| Term Deposits – other Local Authorities | N/A | In-house |
| Term Deposits – Banks and Building Societies | Fitch short-term F1, Long-term A, Individual rating C with support rating 2 or individual rating B with support rating 3, Minimum Sovereign Rating AA | In-house and Fund Managers |
| Term Deposits with Nationalised Banks with Government Guarantee for wholesale deposits | N/A | In-house |
| Term Deposits with Part Nationalised banks by the UK Government | N/A | In-house |

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| | | |
|--|---|---|
| Term Deposits with Banks and Building Societies signed up to the UK Government support to the banking sector | Fitch short-term F1, Long-term A, Individual rating C with support rating 2 or individual rating B with support rating 3, Minimum Sovereign Rating AA | In-house |
| Certificates of Deposit issued by Banks and Building Societies | A1 or P1 | In-house on a buy and hold basis. Fund Managers |
| Short-term Funds (including Money Market Funds) | AAA | In-house and Fund Managers |
| Bond Funds | AAA | In-house and Fund Managers |
| UK Government Gilts | AAA | In-house on a buy and hold basis. Fund Managers |
| Treasury Bills | N/A | Fund Managers |
| | | |

Non-Specified Investments

41. A maximum of 50% of the portfolio will be held in non-specified investments.

| Investment Instrument | Minimum Credit Criteria | Use | Max % of total Investments | Max Maturity Period |
|---|--------------------------------|----------------------------|-----------------------------------|----------------------------|
| Debt Management Agency Deposit Facility (maturities in excess of 1 year) ² | N/A | In-house and Fund Managers | 50% | 3 years |
| Term Deposits – UK Government (maturities in excess of 1 year) | N/A | In-house | 50% | 3 years |

² Debt Management Agency Deposit Facility currently limit deposits to 6 months. The ability to deposit in excess of 1 year is retained if such deposits become available.

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| | | | | |
|--|--|---|-----------------------------------|--|
| Term Deposits – other Local Authorities (maturities in excess of 1 year) | N/A | In-house | 50% | 3 years |
| Term Deposits – Banks and Building Societies (maturities in excess of 1 year) | Fitch short-term F1+, Long-term AA-, Individual rating B, with support rating 2 | In-house and Fund Managers | 50% in-house; 100% External Funds | 3 years |
| Structured Products (eg. Callable deposits, range accruals, snowballs, escalators etc) | Fitch short-term F1+, Long-term AA-, Individual rating B, with support rating 2 or Individual rating B/C with support rating 1 | In-house and Fund Managers | 50% in-house; 100% External Funds | 3 years |
| Certificates of Deposit issued by Banks and Building Societies | A1 or P1 | In-house on a buy and hold basis. Fund Managers | 50% in-house; 100% External Funds | 3 years in-house, 10 years fund managers |
| UK Government Gilts with maturities in excess of 1 year | AAA | In-house on a buy and hold basis. Fund Managers | 50% in-house; 100% External Funds | 5 years in-house, 10 years fund managers |
| Bonds issued by Multilateral development banks | AAA | In-house on a buy and hold basis. Fund Managers | 50% in-house; 100% External Fund | 5 years in-house, 10 years fund managers |
| Bonds issued by a financial institution which is guaranteed by the UK Government | AAA | In-house on a buy and hold basis. Fund Managers | 50% in-house; 100% External Fund | 5 years in-house, 10 years fund managers |

| | | | | |
|-----------------------|-----|---|-------------------------------------|--|
| Supranationals | N/A | In-house. Fund Managers | 50% in-house; 100% of External Fund | 5 years in-house, 30 years fund managers |
| Bond Funds | AAA | In-house and Fund Managers | 50% In-house; 100% External Funds | 5 years in-house, 30 years fund managers |
| Sovereign Bond Issues | AAA | In-house on a buy and hold basis. Fund Managers | 50% in-house; 100% External Funds | 5 year in-house, 30 years fund managers |

Counterparty Limits

42. The Council also manages its credit risk by setting counterparty limits. The matrix below sets out the limits as at 31 December 2009.

| Short Term Rating F1+, Long Term Rating AAA, AA+, AA, AA- | | | | |
|--|----------------|----------|----------|----------|
| | Support | | | |
| Individual | 1 | 2 | 3 | 4 |
| A | £30m* | £30m* | £22m | |
| A/B | £30m* | £22m* | £10m | |
| B | £22m* | £22m* | £10m | |
| B/C | £15m | £15m | | |
| C | £10m | £10m | | |

| Minimum Short Term Rating F1, Long Term Rating A+, A | | | | |
|---|----------------|----------|----------|----------|
| | Support | | | |
| Individual | 1 | 2 | 3 | 4 |
| A | £15m | £15m | £10m | |
| A/B | £15m | £15m | £10m | |
| B | £15m | £15m | £10m | |
| B/C | £10m | £10m | | |
| C | £10m | £10m | | |

* In addition to the standard limit, the highest rated institutions have an additional £5m limit restricted to overnight and call account deposits.

Maturity Limits

43. The Council also manages its counterparty risk by setting maturity limits on deposits, restricting longer term lending to the very highest rated counterparties. The table below sets out the maximum approved limits. The TSMT may further restrict lending criteria in response to changing market conditions.

| Short Term Rating F1+, Long Term Rating AAA, AA+, AA, AA- | | | | |
|--|----------------|----------|----------|----------|
| | Support | | | |
| Individual | 1 | 2 | 3 | 4 |
| A | 3 years | 3 years | 6 mths | |
| A/B | 3 years | 3 years | 3 mths | |
| B | 3 years | 3 years | 3 mths | |
| B/C | 364 days | 6 mths | | |
| C | 6 mths | 3 mths | | |

| Minimum Short Term Rating F1, Long Term Rating A+, A | | | | |
|---|----------------|----------|----------|----------|
| | Support | | | |
| Individual | 1 | 2 | 3 | 4 |
| A | 6 mths | 6 mths | 3 mths | |
| A/B | 6 mths | 6 mths | 3 mths | |
| B | 6 mths | 6 mths | 3 mths | |
| B/C | 3 mths | 3 mths | | |
| C | 3 mths | 3 mths | | |

Other institutions included on the councils lending list

44. In addition to highly credit rated banks and building societies the authority may also invest in AAA rated Money Market funds, Collective Investment Schemes (including LAMIT) and deposits with some local authorities.

Structured Products

45. As at 30 November 2009, the Council had £5m of Structured products within its investment portfolio. Structured products involve varying degrees of additional risk over fixed rate deposits, with the potential for higher returns. It is recommended that the authority continue to use structured products up to a maximum of £20m of the investment portfolio. The Council will continue to monitor structured products and consider restructuring opportunities as appropriate.

External Fund Managers

46. The Council currently has £23.89m invested with external fund managers (as at 30th November 2009). £11.88m with Scottish Widows Investment Partnership (SWIP) and £12.01m with Investec. The aim of the funds is to outperform the Council's in-house investment performance over a rolling three year period.
47. The benchmark for SWIP is the 7 day LIBID (London Interbank BID rate) compounded weekly. The benchmark for Investec is a composite index of 70% of three month LIBID and 30% Merrill Lynch 0-5 year gilt index. The Council will continue to monitor the performance of the externally managed funds against both their benchmarks and the in-house investment returns.

48. The External Fund will have a maximum average duration of 3 years for Investec and 5 years for SWIP.
49. It is recommended that authority to withdraw or advance additional funds to/from external fund managers be delegated to the TMST if economic conditions indicate that this would be in the best interest of the Council.

Treasury Management Advisors

50. In November 2009 the TMST appointed Arlingclose Limited as Treasury Management Advisors to the Council. Arlingclose will:
 - Provide the Council with Investment Advice
 - Assist in the performance monitoring of the external fund managers
 - Provide the Council with market information including credit ratings, other credit information, forecast interest rates for investment and debt
 - Provide technical advice and training to Treasury Management officers and Councillors.

Any advice given by Arlingclose will be considered by the TMST. Any decisions made remain the responsibility of the Council

Performance Monitoring

51. The Council will monitor its Treasury Management performance against other authorities, through its membership of the CIPFA Treasury Management benchmarking club. Latest performance figures will be reported in the Annual Review Report which will be considered by Cabinet in June 2010.

Investment Training

52. All members of the Treasury Management Strategy team are members of a professional accounting body. In addition, key Treasury Management officers receive in-house and externally provided training as deemed appropriate. Key Treasury Management officers will also be encouraged to study towards the new CIPFA and ACT³ joint Certificate on International Treasury Management – Public Finance.

Recommendations

53. The recommendations arising from the updated strategy are set out in the main body of the report.

December 2009

³ Association of Corporate Treasurers