



CLEVELAND FIRE AUTHORITY

Title	TREASURY MANAGEMENT STRATEGY 2010/2011		
Meeting	Cleveland Fire Authority	Date	5th February, 2010
Report of the	Treasurer		
Decision Req'd	Yes	Delegated Powers	N/A

1. Purpose of Report

- 1.1 To update members on matters relating to Treasury Management and compliance with the latest guidance.

2. Recommendations

- 2.1 The Authority is recommended to approve the following recommendations contained in this report:

- i) The responsibility for the effective scrutiny of Treasury activities to be allocated to the Audit and Governance Committee.
- ii) The Prudential Indicators and Limits relating to Capital Expenditure for 2010/2011 to 2012/2013 as per in Section 5.
- iii) The Minimum Revenue Provision (MRP) Statement as per paragraph 7.5
- iv) The Investment Strategy for 2010/2011 to 2012/2013 and related Treasury Prudential Indicators as detailed in Section 8.
- v) The Borrowing Strategy for 2010/2011 to 2012/2013 and related Treasury Prudential Indicators as set out in Section 9.
- vi) The Investment Strategy Counterparty Criteria contained in Section 9.

3. Objectives

- 3.1 This report outlines the Authority's Treasury Management Strategy for 2010/2011, which includes Prudential Indicators for 2010/2011 – 2012/2013 and sets out the expected Treasury operations for this period. It fulfils four key legislative requirements:

- The reporting of Prudential Indicators based on expected capital activities.
- The Authority's Minimum Revenue Provision (MRP) Policy, which sets out how the Authority will pay for capital assets through revenue each year.

- The Treasury Management Strategy Statement which sets out the planned borrowing and investment strategies and the limitations on treasury activity by the use of Treasury Prudential Indicators.
- The Investment Strategy which sets out the Authority's criteria for investment counterparties and limiting exposure to the risk of loss. This strategy is in accordance with the Department of Communities and Local Government (CLG) Investment Guidance.

3.2 The above policies and parameters provide an approved framework within which officers undertake the day to day capital and Treasury activities.

4. Background

4.1 Revised editions of the CIPFA Prudential Code and CIPFA Treasury Management Code of Practice were issued in November 2009 and the CLG is currently consulting on changes to the Investment Guidance. The revised guidance and CLG proposals have been incorporated within this report. If necessary the Investment Strategy will be revised if any elements of the final CLG Investment Guidance result in significant changes.

4.2 The main changes arising from the new guidance are process related and now make it compulsory to adopt practices that the Authority already had in place. One notable change from existing practice is the requirement to nominate a body to be responsible for ensuring effective scrutiny of the Treasury Management Strategy and policies, before making recommendations to Authority. It is recommended that this responsibility be allocated to the Audit and Governance Committee. This year, because the revised guidance was not received until December it was not been possible for the Audit and Governance Committee to review the strategy prior this report being presented to the Authority. The Strategy will be referred to the next meeting of the Audit and Governance Committee on 11th March and if any changes are recommended these will be referred to the next meeting of the Fire Authority on 15th April, 2010.

4.3 The revised Code increases the responsibility of Members' in this area. This will require training for Members to enable better scrutiny of the Treasury policies. Arrangements will be made early in the new year for training to be provided.

4.4 This report covers the following areas:

- Prudential Indicators and Treasury Limits for 2010/2011 to 2012/2013;
- Outlook for Interest Rates;
- Borrowing Strategy;
- Investment Strategy.

5. Prudential Indicators And Treasury Limits For 2010/2011 To 2012/2013

5.1 The Local Government Act 2003 requires the Authority to adopt the CIPFA Prudential Code and produce Prudential Indicators. Each indicator either summarises the expected capital activity or introduces limits upon that activity and reflects the outcome of the Authority's underlying capital appraisal systems. This report updates currently approved indicators and introduces new indicators for 2012/2013.

5.2 Details of the proposed prudential limits are set out in the following sections. The prudential indicators relating to the Borrowing and Investment strategy are detailed sections in sections 7 and 8 to aid understanding of these issues.

5.3 **CIPFA Treasury Management Code of Practice**

5.4 The first Prudential Indicator is confirmation that the Authority has adopted the CIPFA Treasury Management Code of Practice.

5.5 **Capital Expenditure**

5.6 The Authority's capital expenditure plans are summarised below and this is the second of the prudential indicators. A certain level of capital expenditure is supported by the Government through the revenue grant system. For 2010/2011 the Government have provided a supported borrowing allocation of £0.448m. Any decisions to spend above this level will be classified as unsupported capital expenditure and the Authority needs to have regard to following when approving such proposals:

- 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);
- Practicality (e.g. the achievability of the forward plan).

5.7 The revenue consequences of capital expenditure, particularly the unsupported capital expenditure, will need to be paid for from the Authority's own resources. There are no plans to use unsupported borrowing in 2010/2011.

5.8 Capital expenditure can be funded for immediately by applying capital resources such as capital grants or revenue resources, but if these resources are insufficient any residual capital expenditure will add to the Authority's borrowing need.

5.9 As part of the Medium Term Financial Strategy the Authority is asked to approve the 2010/2011 Capital Programme, as summarised below.

Capital Expenditure £m	2009/10 Original	2009/10 Revised	2010/11 Estimate	2011/12 Estimate	2012/13 Estimate
Capital Expenditure	1,371	968	2,888	615	615
Financed by:					
Capital grants	626	0	2,136	0	0
Capital reserves	0	0	0	0	0
Revenue	0	0	0	0	0
Net financing need for the year	745	968	752	615	615

The related impact of the above movements on the revenue budget are show overleaf.

£m	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
Revenue Budgets				
Interest on Borrowing	79	118	158	158
Net General Fund Borrowing Cost	49	103	128	138
Investment income	(30)	(15)	(30)	(20)

5.10 Affordability Prudential Indicators

5.11 These indicators are intended to give an indication of the affordability of the planned capital expenditure financed by borrowing.

Incremental Impact of Capital Expenditure on Authority Tax

This indicator identifies the revenue costs associated with new schemes introduced to the three year Capital Programme recommended in the budget strategy report compared to the Authority's existing approved commitments and current plans.

	Forward Projection 2010/11	Forward Projection 2011/12	Forward Projection 2012/13
CouncilTax - Band D	£0.20	£0.16	£0.16

Ratio of Financing Costs to Net Revenue Stream

This shows the net cost of capital borrowing as a percentage of the net budget, which is spent on servicing debt. The upwards trend reflects the increasing costs associated with each year's capital expenditure and the expected reduction in investment income.

%	2010/11 Estimate	2011/12 Estimate	2012/13 Estimate
Ratio	1.14%	1.18%	1.20%

6. Outlook For Interest Rates

6.1 The table overleaf provides the latest interest rate forecasts provided by Butlers.

Medium-Term Rate Estimates (averages)

* Borrowing Rates

Annual Average %	Bank Rate	Money Rates		PWL B Rates*		
		3 month	1 year	5 year	20 year	50 year
2008/09	3.9	5	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	1.5	2.3	4	5	5.2
2011/12	2	2.5	3.3	4.3	5.3	5.3
2012/13	4.5	4.8	5.3	5.3	5.5	5.3

- 6.2 Short-term rates are expected to remain low for a considerable time. The recovery in the economy has commenced but is insipid. There is a danger that the reversal of monetary easing with rate cuts and Quantitative Easing (QE) could trigger a dip back to negative growth and a W-shaped economic recovery path. Otherwise known as a 'dead cat bounce'
- 6.3 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 economic growth prospects, as will the lacklustre growth of broad money supply.
- 6.4 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 VAT and National Insurance already scheduled for 2010. Without a rebound in this key element of UK economy, any recovery is set to be weak and protracted.
- 6.5 The MPC may 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 uncertain given the personal sector's reluctance to take on more debt and add to its already unhealthy balance sheet.
- 6.6 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 Monetary Policy Committee (MPC) to increase rates will remain moderate. However, some increase will be seen as necessary in 2010 to counter the effects of external cost pressures (as commodity price increases filter through) and to avoid damage that sterling could endure if the UK is seen to defy an international moves to commence policy exit strategies.
- 6.7 The outlook for long-term fixed interest rates is less favourable. While the UK's fiscal burden should ease in the future as painful action is taken, 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. 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. 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.
- 6.8 Accordingly interest rates are expected to increase to facilitate this.

7. Borrowing Strategy

7.1 The uncertainty over future interest rates presents risks for Treasury activity. As a result the Authority will take a cautious approach to its Treasury Strategy.

7.2 **The Authority's Borrowing Need (the Capital Financing Requirement)**

7.3 The Authority's Capital Financing Requirement (CFR) is simply the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Authority's underlying borrowing need.

£m	2009/10 Original	2009/10 Revised	2010/11 Estimate	2011/12 Estimate	2012/13 Estimate
CFR b/f	3,619	2,872	3,586	4,038	4,284
Capital Expenditure Financed by Borrowing	660	968	763	615	615
Less MRP/VRP and other financing movements	297	254	311	369	405
CFR c/f	3,982	3,586	4,038	4,284	4,494

7.4 The Authority is required to pay off an element of the CFR each year through a revenue charge called the Minimum Revenue Provision (MRP), although it is also allowed to undertake additional voluntary payments (VRP).

7.5 CLG Regulations require the Authority to approve an **MRP Statement** in advance of each year. The Authority is recommended to approve the following MRP Statement

- For capital expenditure incurred before 1st April, 2008 the Authority's MRP policy is to calculate MRP in accordance with former CLG Regulations. The Authority makes Voluntary Revenue Payments for vehicles and equipment, which is in excess of the amount required by these regulations, based on asset life.
- From 1st April, 2008 the Authority calculates MRP based on asset life for all assets.

7.6 **Debt and Investment Projections 2010/11 – 2012/2013**

7.7 The table below sets out the Authority's projected borrowing requirement and level of debt.

£m	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
External Debt				
Debt at 1 April	2,000	2,000	3,000	4,000
Expected change in debt	0	1,000	1,000	0
Debt at 31 March	2,000	3,000	4,000	4,000
Capital Finance Requirement	3,982	3,586	4,038	4,284

- 7.8 The table shows that new borrowing may be necessary in 2010/2011. However, in the short term the Authority can continue to use its balance sheet resources to defer borrowing. This reduces counterparty risk and shelters against the expected fall in investments returns. If the LOBO is recalled this could also be temporarily refinanced by using these resources. The key risk is ensuring that when the Authority does need to borrow that it is not at too high a rate. Long-term fixed interest rates are at risk of being higher over the medium term, and short term rates are expected to rise but from a historically exceptionally low level. The Authority needs to ensure that it achieves benefits from those historically low short term rates whilst retaining the flexibility to lock into longer term rates before they rise significantly. In these circumstance not only is the level of interest rate a factor but the speed at which it is changing.
- 7.9 The Treasurer, 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
- 7.10 **Limits to Borrowing Activity**
- 7.11 Within the Prudential Indicators there are a number of key indicators to ensure the Authority operates its activities within well defined limits
- 7.12 For the first of these the Authority 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 following two financial years . This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

£m	2009/10 Revised	2010/11 Estimate	2011/12 Estimate	2012/13 Estimate
Gross Borrowing	2,000	3,000	4,000	4,000
Investments	6,709	3,314	2,760	2,218
Net Borrowing	(4,709)	(314)	1,240	1,782
CFR	3,586	4,038	4,284	4,494

Borrowing Limits	2009/10 Revised	2010/11 Estimate	2011/12 Estimate	2012/13 Estimate
Operational Limit	4,000	4,500	4,500	4,500
Authorised limit	6,000	6,500	6,500	6,500

- 7.13 The Operational Limit is the likely limit the Authority will require and is aligned closely with the actual CFR on the assumption that cashflow is broadly neutral.
- 7.14 The Authorised Limit for External Debt is a further key prudential indicator to control the overall level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by full Authority. In practice it needs to take account of the range of cash flows that might occur for the Authority in addition to the CFR.

7.15 The Treasurer reports that the Authority complied with these Prudential Indicators in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

7.16 The Authority has some flexibility to borrow funds this year for use in future years. The Treasurer may do this under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. Whilst the Treasurer will adopt a cautious approach to any such borrowing, where there is a clear business case for doing so borrowing may be undertaken to fund the approved Capital Programme or to fund future debt maturities. Any borrowing in advance of need will be reported to the Authority in the next Treasury Management Report.

8. **Investment Strategy**

8.1 The primary objectives of the Authority's investment strategy in order of importance are:

- safeguarding the re-payment of the principal and interest of its investments on time;
- ensuring adequate liquidity;
- investment return.

8.2 Following the economic background above, the current investment climate has one overriding 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. The Authority is also mitigating that risk by the pooling arrangement previously approved with Hartlepool Borough Council.

8.3 **Investment Projections 2010/2011 – 2012/2013**

8.4 The table below sets out estimates for the expected level of resource for investment or use to temporarily finance capital expenditure.

Year End Resources £m	2008/09 Outturn	2009/10 Estimate	2010/11 Estimate	2011/12 Estimate	2012/13 Estimate
Balances and Reserves	4,941	5,191	4,352	3,380	3,109
Working Capital*	1,133	3,500	0	0	0
(Under)/over borrowing	(829)	(1,982)	(1,038)	(620)	(891)
Expected Investments	5,245	6,709	3,314	2,760	2,218

*The working capital balance is based on the best estimate of debtors and creditors at the year end and may vary.

8.5 The table assumes that no new borrowing will be taken in the current year and only £1m of new borrowing will be taken in 2010/2011. As described above, this borrowing will be deferred unless long term rates start to rise sharply.

8.6 **Benchmarking**

8.7 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. Security and liquidity benchmarks are new requirements to the Member reporting and benchmarks in these areas are significantly less developed. The application of these is also more subjective in nature.

- 8.8 These benchmarks are simple targets (not limits) and so may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is to assist monitoring and illuminate any changes to the strategy. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.
- 8.9 The benchmark for monitoring security is based on the historical risk of default associated with the credit rating of an organisation. The higher rated counterparties have a lower rate of historic default.
- 8.10 The Table below sets out the historic default percentages for each type of credit rated institution and the period of deposit.

Rating/Years	Maturity Period in Years				
	1	2	3	4	5
AAA	0.000%	0.000%	0.000%	0.000%	0.000%
AA	0.000%	0.000%	0.000%	0.030%	0.060%
A	0.030%	0.150%	0.300%	0.440%	0.650%
BBB	0.240%	0.780%	1.480%	2.240%	3.110%
BB	1.150%	3.300%	5.340%	7.230%	9.340%
B	1.310%	3.420%	5.540%	8.020%	9.870%
CCC	21.910%	28.010%	33.020%	36.760%	42.670%
Council	0.000%	0.000%	0.000%	0.000%	0.000%

- 8.11 The Authority will aim to ensure that the historic default probability of its investment portfolio will not exceed 0.2%.
- 8.12 An additional proposed benchmark is the average risk of default. This is based on the historic risk of default multiplied by the value of each investment. It does not constitute the actual expectation of loss. Rather it is intended to give a guide as to the relative security of investments. For the forthcoming year this is expected to not exceed £12,000.
- 8.13 To ensure adequate Liquidity the Authority seeks to maintain a bank overdraft of £0.5m. In addition the Pooled Investment Fund will include the use of call accounts to enable cash to be obtained with immediate notice. The proposed benchmark for monitoring liquidity is 'Weighted Average Life'. This reflects the average number of days to maturity for investments and therefore gives an indication of the liquidity profile of investments held. For the forthcoming year because of the lack of value obtainable for deposits exceeding 12 month and the need to ensure maximum security this benchmark is expected to be 0.5 years, with a maximum of 3 years.
- 8.14 **Investment Counterparty Selection Criteria**

- 8.15 The primary principle governing the Authority'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 Authority 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 Authority's prudential indicators covering the maximum principal sums invested.
- 8.16 The Authority places its investment in the pooled investment Fund, the Treasurer will liaise with Hartlepool Borough Council to ensure that a counterparty list is maintained in compliance with the following criteria and will revise the criteria and submit them to Authority for approval as necessary. This criteria is separate to that used for Specified and Non-Specified investments as it provides an overall pool of counterparties considered high quality that the Authority may use rather than defining what its investments are. Further details of the Specified/Non Specified criteria are contained at Appendix 1.
- 8.17 The rating criteria use the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the Authority'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 Authority'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.
- 8.18 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 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 on a daily basis before investments are made. For instance a negative rating watch applying to a counterparty at the minimum Authority criteria will be suspended from use, with all others being reviewed in light of market conditions The criteria for providing a pool of high quality investment counterparties (both Specified and Non-specified investments) is:
- **Banks** – the Authority will use UK banks which have at least the following Fitch (or Moody's and Standard and Poors equivalent) ratings (where rated):
 - Short Term – F1
 - Long Term – A-
 - Individual / Financial Strength – C (Fitch / Moody's only)
 - Support – 3 (Fitch only)

- **Building Societies** – the Authority will invest with where they have asset base of more than £1bn and form part of the HM Treasury Guarantee scheme, or where Societies meet the ratings for banks outlined above. These are currently excluded from the operational counterparty list as a result of reduced credit ratings in the sector generally but are included in the Authority’s criteria on the basis that they may be reinstated if rating improve.
- **Other Local Authorities.**
- **Debt Management Office** – this is a UK Government Agency which manages debt on behalf of the Government.

8.19 Note that the above criteria only includes UK institutions and therefore has never included Icelandic banks, owing to the risk that if these banks ran into financial difficulties the Icelandic Government may not have been able to underwrite depositors funds.

8.20 The Authority receives a Treasury Management service provided by Hartlepool Borough Council. As a result of this collaboration both organisations already share the same Treasury Management Strategies and criteria determining approved investment counterparties. The limits need to be the same for each member of the Fund although it should be noted that the exposure of each party is limited to their proportionate share of the overall fund. It is currently estimated 1/4th of investments will relate to the CFA and 3/4th to HBC, although these proportions will change over time depending on the amounts invested by the CFA and HBC.

8.21 The table below shows the Limits proposed for the Pooled Investment Fund and illustrates the ‘implied’ limit for the CFA, which is based on the current proportionate share of the overall investments.

	Fitch	Moody’s	Standard & Poors	Limit for Investment Fund	CFA ‘Implied Limit	Time Limit
Upper Limit Category	F1+/AA-	P-1/Aa3	A-1+/AA-	£10m	£2.5m	3 years
Middle Limit Category	F1/A-	P-1/A3	A-1/A-	£7m	£1.75m	364 days
Lower Limit Category	Unrated bank subsidiaries and building societies with assets over £1bn			£2m	£0.5m	6 months
Other Limits	Other Local Authorities			No limit	No Limit	3 years
	Nationalised Banks			£ 10m	£0.5m	3 years
	Debt Management Office			£20m	£5m	3 years
	UK Banks covered by UK Government Guarantee			£10m	£2.5m	3 years

8.22 The above limits set the overall framework for managing the investment fund. In practice the Chief Financial Officer of Hartlepool Borough Council uses his delegated powers to set operational limits which further tighten the lending criteria as necessary in response to developments caused by the Global ‘credit crunch’. These actions reflect

the Chief Finance Officer's assessment of risk which is particularly important as credit ratings are not a guarantee of an organisation's financial strength and can only provide a starting point for assessing risk. This flexibility is needed to take advantage of opportunities arising where maximum security can be obtained to reduce the risk of financial loss, while still benefitting from competitive rates of return.

8.23 In the normal course of the Authority'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.

8.24 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 Authority's liquidity requirements are safeguarded. This will also be limited by the longer term investment limits.

8.25 **Economic Investment Considerations**

8.26 Expectations on shorter-term interest rates, on which investment decisions are based, show the likelihood of the current 0.5% Bank Rate remaining flat but with the possibility of a rise in mid-2010. The Authority's investment decisions are based on comparisons between the rises priced into market rates against the Authority's and advisers own forecasts.

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

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

8.29 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.

8.30 **Sensitivity to Interest Rate Movements**

8.31 The Authority will be required to disclose in its Statement of Accounts the impact of risks on the Authority'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 short interest rate changes.

£m	2010/11 Estimated 1%	2010/11 Estimated -1%
Revenue Budgets		
Interest on Borrowing	128	108
Investment income	(50)	0
Net General Fund Borrowing Cost	78	108

8.32 Treasury Management Limits on Activity

8.33 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.

8.34 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

8.35 The Proposed limits are as follows:

Interest rate Exposures	2010/11	2011/12
	Upper	Upper
Limits on fixed interest rates:		
• Debt	100%	100%
• Investments	-70%	-50%
Limits on fixed interest rates based on net debt	30%	50%
Limits on variable interest rates		
• Debt	100%	100%
• Investments	100%	100%
Limits on variable interest rates based on net debt	0%	0%

8.36 Limits for the 'Maturity Structure of Borrowing' are intended to reduce the Authority's exposure to large fixed rate sums falling due for refinancing, and are required for upper

and lower limits. Given the Authority's relatively low level of borrowing and the need for flexibility to obtain new borrowing at the most cost effective rate, the Authority is advised to avoid unnecessary constraint as a result of setting these limits.

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%

8.37 Total principal funds invested for greater than 364 days – These limits are set with regard to the Authority'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.

	1 year	2 years	3 years
Maximum	50%	30%	20%

8.38 **Performance Indicators**

8.39 The Code of Practice on Treasury Management requires the Authority 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. The Authority will produce the following Performance Indicators for information and explanation of its past Treasury activity:

- Average rate of borrowing for the year compared to average available;
- Debt – Average rate movement year on year;
- Investments – returns above the 7 day LIBID rate.

8.40 **Treasury Management Advisers**

8.41 The Authority uses Butlers as its treasury management consultants. The company provides a range of services which include:

- Technical support on treasury matters, capital finance issues and the drafting of Member reports;
- Economic and interest rate analysis;
- Debt services which includes advice on the timing of borrowing;
- Debt rescheduling advice surrounding the existing portfolio;
- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings/market information service comprising the three main credit rating agencies;

8.42 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 Authority. This service is subject to regular review.

8.43 **Member and Officer Training**

- 8.44 The increased role of Members and the need to ensure officers dealing with Treasury Management are well trained and kept up to date requires a suitable training process for Members and officers. Officers already attend regular training courses provided by Butlers. Arrangements will be made for some training for Members in the early part of the year. This is likely to take the form of a number of a workshop session involving Butlers.

Credit And Counterparty Risk Management

The Office of the Deputy Prime Minister (now CLG) issued Investment Guidance on 12th March, 2004 and this forms the structure of the Authority's policy below. The CLG is currently consulting over revisions to the Guidance and where applicable the Consultation recommendations have been included within this policy.

The key intention of the Guidance is to maintain the current requirement for authorities to invest prudently and that priority is given to security and liquidity before interest return. In order to facilitate this objective the guidance requires this Authority to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Authority has adopted the Code and applies its principles to all investment activity. In accordance with the Code, the Treasurer has produced its treasury management practices covering investment counterparty policy which requires approval each year.

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

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

The strategy proposed for approval by the Authority is set out below.

Strategy Guidelines – The main strategy guidelines are contained in the body of the Treasury Strategy Statement. Because the Authority's investment funds will be pooled with Hartlepool Borough Council, it will be the limits set by 'the Council' which will apply. These are set out below. The Authority's share of these limits will equate to approximately 1/4th based on its share of the pool.

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

1. The UK Government (such as the Debt Management Office, UK Treasury Bills or a Gilt with less than one year to maturity).
2. A local authority, parish Authority or community Authority.
3. Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. This covers pooled investment vehicles, such as money market funds, rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.
4. A body that has been awarded a high credit rating by a credit rating agency (such as a bank or building society). This covers bodies with a minimum rating of A- (or the equivalent) as rated by Standard and Poor's, Moody's or Fitch rating agencies. Within these bodies, and in accordance with the Code, the Authority has set additional criteria to set the time and amount of monies which will be invested in these bodies. This criteria is:

	Fitch	Moody's	Standard & Poors	Limit for Investment Fund	Time Limit
Upper Limit Category	F1+/AA-	P-1/Aa3	A-1+/AA-	£10m	364 days
Middle Limit Category	F1/A-	P-1/A3	A-1/A-	£7m	364 days
Other Institution Limits	Other Local Authorities			No Limit	364 days
	Nationalised Banks			£10m	364 days
	Debt Management Office			£20m	364 days
	UK Banks covered by UK Government			£10m	364 days

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

- **Building societies not meeting the basic security requirements under the specified investments.** The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings. The Investment Fund may use building societies with assets over £1bn. These will be limited to £2.5m over 3 months.
- Any **bank or building society** that has a minimum long term credit rating of A- for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).

	Fitch	Moody's	Standard & Poors	Money Limit	Time Limit
Upper Limit Category	F1+/AA-	P-1/Aa3	A-1+/AA-	£10m	3 years
Other Local Authorities				No limit	3 years
Nationalised Banks				£7m	3 years
Building Societies				£2m	
Debt Management Office				£20m	3 years
UK Banks covered by UK Government				£7m	3 years

The Monitoring of Investment Counterparties - The credit rating of counterparties will be monitored regularly. The Authority receives credit rating advice from its advisers, Butlers, on a daily basis, and as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Treasurer and if required new counterparties which meet the criteria will be added to the list.

**A. EMMERSON
TREASURER TO THE AUTHORITY**