Report on the Council's Prudential Indicators for 2009/10 to 2011/12 and the Treasury Management Strategy for 2009/10

This report outlines the Council's prudential indicators for 2009/10 – 2011/12 and sets out the expected treasury operations for this period. It fulfils four key legislative requirements:

- The reporting of the **prudential indicators** setting out the expected capital activities;
- The Council's **Minimum Revenue Provision (MRP) Policy**, which sets out how the Council will pay for capital assets through revenue each year;
- The **treasury management strategy statement** which sets out how the Council's treasury service will support the capital decisions taken above;
- The **investment strategy** which sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss.

Recommendations;

1. **The Council is recommended to adopt the prudential indicators and limits for 2009/10 to 2011/12 contained within the report. The main indicators are summarised in the table below:**

	2007/08 Actual	2008/09 Revised	2009/10 Estimate	2010/11 Estimate	2011/12 Estimate
Capital Expenditure (Indicators 2 & 3)	£10.597 m	£12.900m	£16.527 m	£9.207 m	£7.481 m
Capital financing requirement (Indicators 4 & 5)	-£0.784 m	-£0.784 m	-£0.784 m	-£0.784 m	-£0.784 m
Authorised limit for external debt (Indicator 6)	£5.0 m	£5.0 m	£5.0 m	£5.0 m	£5.0 m
Operational boundary for external debt (Indicator 7)	£0.5 m	£0.5 m	£0.5 m	£0.5 m	£0.5 m
Ratio of financing costs to net revenue stream – General Fund (Indicators 9 & 10)	-10.73 %	-10.15 %	-6.04 %	-4.91 %	-4.86 %
Ratio of financing costs to net revenue stream – HRA (Indicators 9 & 10)	-11.11 %	-10.51 %	-6.26 %	-5.09 %	-5.03 %
Incremental impact of capital investment decisions on the Band D Council Tax (Indicator 11)	N/a	-£1.17	£0.59	£3.11	£4.09
Incremental impact of capital investment decisions on weekly housing rents levels (Indicator 12)	N/a	£0.82	£0.03	£1.02	£1.08

2. **Members are recommended to approve the treasury management strategy for 2009/10. The treasury prudential indicators are set out in the tables below;**

Exposure to fixed/variable interest rates (Indicators)	**2009/10 Upper**	**2010/11 Upper**	**2011/12 Upper**
Limits on fixed interest rates (14)	100%	100%	100%
Limits on variable interest rates (15)	30%	30%	30%

Maturity Structure of fixed interest rate borrowing						
(Indicator 16)	**2009/10**		**2010/11**		**2011/12**	
	Lower	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	0%	100%	0%	100%	0%	100%
12 months to 2 years	0%	0%	0%	0%	0%	0%
2 years to 5 years	0%	0%	0%	0%	0%	0%
5 years to 10 years	0%	0%	0%	0%	0%	0%
10 years and above	0%	0%	0%	0%	0%	0%
Maximum principal sums invested for 1 year or more	£30 m		£30 m		£30 m	
Investment returns to exceed the 7 day LIBID rate by;	0.10 %		0.10%		0.10%	

3. **Members are recommended to approve the Council's Statement on the Minimum Revenue Provision.**

4. **Members are recommended to approve the investment strategy for 2009/10 contained in the treasury management strategy, and the detailed criteria included within it, specifically approving:**
    - **The criteria for specified investments**
    - **The criteria for non-specified investments**

The Prudential Indicators 2009/10 – 2011/12

1. The Local Government Act 2003 required the Council to adopt the CIPFA Prudential Code and to produce prudential indicators. This report revises the indicators for 2008/09, 2009/10 and 2010/11, and introduces new indicators for 2011/12. Each indicator either summarises the expected activity or introduces limits upon the activity, and reflects the outcome of the Council's underlying capital appraisal systems.

2. Within this overall prudential framework there is a clear impact on the Council's treasury management activity, either through borrowing or investment activity. As a consequence, the treasury management strategy for 2009/10 and the treasury indicators form part of this report.

Capital Expenditure Plans

3. The first prudential indicators govern the Council's capital expenditure plans, its net borrowing position and its Capital Financing Requirement (CFR). The Council's capital expenditure plans are summarised below. Capital expenditure can be financed immediately (by resources such as contributions from revenue, capital receipts and capital grants), so that with no unfinanced expenditure there is no need to borrow.

4. A certain level of capital expenditure will be grant supported by the Government; anything above this level will be unsupported and will need to be paid for from the Council's own resources. The Government has the power to restrict the level of external debt undertaken by either all councils as a whole or of a specific council, although these powers have not yet been exercised.

5. The key risk to the plans is that the level of Government support has been estimated and is therefore subject to change. Similarly some of the estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale.

6. **The Council is recommended to approve the capital expenditure estimates presented in Table 1 as Prudential Indicators 2 and 3.**

Table 1: Estimated Capital Expenditure 2008/09 to 2011/12

Portfolio	**2007/08 Actual £'000**	**2008/09 Revised Estimate £'000**	**2009/10 Original Estimate £'000**	**2010/11 Original Estimate £'000**	**2011/12 Original Estimate £'000**
Finance & Performance Management	0	241	90	0	0
Corporate Support & ICT Services	589	678	1,394	2,107	380
Leisure & Young People	97	320	1,898	62	63
Environmental Protection	2,074	607	1,875	0	0
Planning & Economic Development	285	872	1,630	0	0
Civil Engineering & Maintenance	724	254	789	557	557
Housing General Fund	1,180	1,721	2,011	1,060	1,060
Total General Fund	**4,949**	**4,693**	**9,687**	**3,786**	**2,060**
HRA	5,601	8,153	6,790	5,371	5,371
Housing DLO	47	54	50	50	50
Total Housing Revenue Account	**5,648**	**8,207**	**6,840**	**5,421**	**5,421**
TOTAL	**10,597**	**12,900**	**16,527**	**9,207**	**7,481**

The Council's Capital Financing Requirement

7. The Council's Capital Financing Requirement (CFR) is the total capital expenditure which has not yet been financed from either revenue contributions or capital income. It is essentially a measure of the Council's underlying borrowing need; any unfinanced capital expenditure will increase the Council's CFR. Table 2 demonstrates that all projected capital expenditure over the current and the next three financial years is expected to be financed, and that the Council's CFR is expected to remain unchanged.

8. **Members are asked to agree that the Council has complied with the requirement of Prudential Indicator 1 by keeping net borrowing below the appropriate CFR in 2007/08, and that no difficulties are envisaged for the financial years 2008/09 to 2011/12.**

9. **Members are further asked to approve Prudential Indicators 4 and 5, the Capital Financing Requirement from 2007/08 to 2011/12, contained within Table 2**

Table 2: Capital Expenditure Financing and its effect on the CFR

	2007/08 Actual £'000	**2008/09 Revised £'000**	**2009/10 Estimate £'000**	**2010/11 Estimate £'000**	**2011/12 Estimate £'000**
General Fund					
Capital Expenditure	**4,949**	**4,693**	**9,687**	**3,786**	**2,060**
Financed by:					
Capital receipts	4,053	3,721	7,476	3,231	1,504
Capital grants	896	972	2,211	555	556
Revenue Contributions	0	0	0	0	0
Total Financed Expenditure	**4,949**	**4,693**	**9,687**	**3,786**	**2,060**
Net financing need for the year	**0**	**0**	**0**	**0**	**0**
Opening CFR	**22,019**	**22,019**	**22,019**	**22,019**	**22,019**
CFR arising during the year	**0**	**0**	**0**	**0**	**0**
Closing CFR	**22,019**	**22,019**	**22,019**	**22,019**	**22,019**
HRA					
Capital Expenditure	**5,648**	**8,207**	**6,840**	**5,421**	**5,421**
Financed by:					
Capital receipts	11	0	0	0	0
Capital grants	41	50	50	50	50
Revenue Contributions	5,596	8,157	6,790	5,371	5,371
Total Financed Expenditure	**5,648**	**8,207**	**6,840**	**5,421**	**5,421**
Net financing need for the year	**0**	**0**	**0**	**0**	**0**
Opening CFR	**-22,803**	**-22,803**	**-22,803**	**-22,803**	**-22,803**
CFR arising during the year	**0**	**0**	**0**	**0**	**0**
Closing CFR	**-22,803**	**-22,803**	**-22,803**	**-22,803**	**-22,803**
General Fund CFR	22,019	22,019	22,019	22,019	22,019
HRA CFR	-22,803	-22,803	-22,803	-22,803	-22,803
Total CFR	**-0.784**	**-0.784**	**-0.784**	**-0.784**	**-0.784**

10. Local authorities are required to repay an element of the accumulated General Fund capital spend – represented by the CFR - through an annual revenue charge (the Minimum Revenue Provision, or MRP).

11. CLG Regulations will require full Council to approve an MRP Statement. This will need to be approved in advance of each financial year. As the timetable for consultation is very tight, members are asked to approve the following MRP statement:

    As the Council is currently debt-free and intends to remain so for the foreseeable future, there is no requirement to make a provision for external debt repayment. If the Council identifies a need to borrow externally, the Council will draw up a minimum revenue policy in accordance with proper accounting practice, and will present this to members for approval.

12. **Members are asked to approve the Council's Minimum Revenue Provision Statement, set out in paragraph 11 above.**

Limits to Borrowing Activity

13. Prudential Indicators 6, 7 and 8 are intended to ensure that the Council operates its external borrowing activities within well defined limits. The first two of these are:

    - The Authorised Limit for External Debt. This represents a limit beyond which external debt is prohibited, and needs to be approved by full Council. It reflects the level of external debt which could be afforded in the short term, but is not sustainable in the longer term. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

    - The Operational Boundary for External Debt. This indicator is based on the expected maximum external debt during the course of the year; it is not a limit.

14. The Council became debt-free on 29th March 2004, and intends to remain debt-free for the foreseeable future, meaning that the Authorised Limit is unlikely to be breached. The Director of Finance & ICT confirms that the Council has remained within these two limits during the current year, and does not foresee any difficulty in continuing to do so.

15. **The Council is recommended to approve the Authorised Limit and Operational Boundary set out in Table 3 as Prudential Indicators 6 and 7.**

Table 3: The Authorised and Operational Limits of External Debt

	2007/08 Revised £ m	2008/09 Estimate £ m	2009/10 Estimate £ m	2010/11 Estimate £ m
Authorised limit	5.0	5.0	5.0	5.0
Operational boundary	0.5	0.5	0.5	0.5

16. In order to comply with Prudential Indicator 8 the Council must 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 2009/10 and next two financial years. This allows flexibility for limited early borrowing for future years.

17. The Director of Finance & ICT confirms that the Council has complied with this prudential indicator throughout the current year and does not envisage difficulties for the foreseeable future. This view takes into account current commitments, existing plans, and proposals contained within this budget report. The Council's net debt position as at 31 March 2008 and its estimated position as at 31 March 2009 is shown for information in Table 4.

Table 4: Net external debt on the final day of the financial year				
	31 March 2008 Actual £'000	Rate %	31 March 2009 Estimate £'000	Rate %
External debt	0		0	
Less transferred debt	- 559	5.97	- 534	2.88
Total Debt	**- 559**		**- 534**	
Fixed Investments	-57,250	5.88	-61,000	5.70
Variable Investments	-2,055	5.25	-1,500	2.74
Total Investments	**-59,305**		**-62,500**	
Net Investments	**-59,864**		**-63,034**	

Affordability Prudential Indicators

18. The previous sections cover prudential indicators designed to examine capital expenditure and control of borrowing: prudential indicators in this section are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's financial affairs, and identify the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

19. The estimates of financing costs include current commitments and the proposals in this budget report.

20. Prudential Indicators 9 and 10 are the actual and estimated ratios of financing costs to net revenue stream for the General Fund and Housing Revenue Accounts, and are shown in Table 5. As the Council is debt-free, these are based on investment income and are therefore negative.

Table 5: Actual and estimated ratios of financing Costs to net revenue stream					
	2007/08 Actual %	2008/09 Revised Estimate %	2009/10 Estimated Forecast %	2010/11 Estimated Forecast %	2011/12 Estimated Forecast %
General Fund	- 10.73	- 10.15	- 6.04	- 4.91	- 4.86
HRA	- 11.11	- 10.51	- 6.26	- 5.09	- 5.03

21. Prudential Indicator 11 concerns an estimate of the incremental impact of capital investment decisions on the Band D Council Tax over the next three financial years, and is shown in Table 6. This indicator identifies the revenue costs associated with new schemes introduced to the capital programme considered as Appendix 15 to this report, compared to the capital programme examined for the 2008/09 Prudential Indicators. The assumptions are based on the budget, but will invariably include some estimates, such as the level of government support in future years.

22. Prudential Indicator 12 examines estimates of the incremental impact of capital investment decisions on housing rent levels over the next three financial years. Similar to the Council Tax calculation, this indicator identifies the trend in the cost of proposed changes in the part of the capital programme relating to the Housing Revenue Account. It compares the most recent programme to that examined for the 2008/09 Prudential Indicators, and is expressed as a discrete impact on weekly rent levels.

Table 6: Incremental impact of capital investment decisions on Council tax and rents				
	2008/09 Revised £	**2009/10 Estimate £**	**2010/11 Estimate £**	**2011/12 Estimate £**
Band D Council Tax	-1.17	0.59	3.11	4.09
Housing rents levels	0.82	0.03	1.02	1.08

23. It should be emphasised that these are theoretical, and do not imply an actual requirement to raise either Council Tax or housing rent levels. Any move to raise housing rent levels will be constrained by the rent restructuring controls.

Treasury Management Strategy 2009/10 – 2011/12

24. The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators considered so far relate to the affordability and impact of capital expenditure decisions and govern the Council's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures that the Council meets the "balanced budget" requirement under the Local Government Finance Act 1992. There are specific treasury prudential indicators included within this strategy which require approval.

25. The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). This Council adopted the Code of Practice on Treasury Management on 22 April 2002, and as a result formulated a Treasury Management Policy Statement (approved by Cabinet on 18 October 2004). This adoption meets the requirements of the first of the treasury prudential indicators (Prudential Indicator 13).

26. The Council's Treasury Management policy requires an annual strategy to be reported to Council in advance of the first financial year to which it relates, outlining the expected treasury activity for the following three financial years. A key requirement of this report is to explain both the risks and the management of the risks associated with the treasury service. A further treasury report is produced within six months of the year-end to report on actual activity for the year.

27. This strategy covers:

- The Council's debt and investment projections;
- The expected movement in interest rates;
- The Council's borrowing and investment strategies;
- Treasury performance indicators;
- Specific limits on treasury activities;

Debt and Investment Projections 2009/10 – 2011/12

28. The borrowing requirement comprises the expected movement in the CFR and any maturing debt which will need to be re-financed. Table 7 shows this effect on the treasury position over the next three years. It also highlights the expected change in investment balances, although as a matter of prudence it does not include an estimate for capital receipts from proposed land sales.

29. Although the Council is debt-free and expects to remain so for the foreseeable future, there is a reducing element of debt taken out on behalf of other local authorities. Epping Council has repaid the underlying external debt in full from its own resources; the authorities concerned are paying the Council their share of the debt plus interest in instalments. This is shown as negative debt, as it represents income to the Council.

Table 7: Estimated Treasury position as at 31 March, 2009 to 2012				
	2009 Revised £'000	**2010 Estimate £'000**	**2011 Estimate £'000**	**2012 Estimate £'000**
External Debt				
External debt	0	0	0	0
Less transferred debt	- 534	- 508	- 481	- 452
Total debt	**- 534**	**- 508**	**- 481**	**- 452**
Investments				
Investment portfolio	61,000	57,000	54,000	52,000
Funds held in short notice accounts	1,500	1,500	1,500	1,500
Total investments	**62,500**	**58,500**	**53,500**	**52,500**
Change from previous year	+3,195	- 4,000	-3,000	-1,000
Annual net interest income	3,521	2,126	1,753	1,761

Economic Forecast

Table 8: Expected movements in interest rates		**(Source: Butlers, January 2009)**		
		Market investment rates		
As at end of:	**Base Rate %**	**3 month %**	**6 month %**	**12 month %**
December 2008	2.00	3.0	3.2	3.3
March 2009	1.00	2.0	2.2	2.4
June 2009	0.75	1.5	1.6	1.8
September 2009	0.50	1.5	1.6	1.7
December 2009	1.00	1.6	1.7	1.8
March 2010	1.25	1.7	1.9	2.0

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

31. The sharp downturn in world commodity, food and oil prices, the lack of domestic wage pressures and weak retail demand promises a very steep decline in inflation in the year ahead. In the recent pre-Budget Report, the Treasury suggested RPI inflation could fall to minus 2.25% by September 2009. Inflation considerations will not be a constraint upon Bank of England policy action. Indeed, the threat of deflation strengthens the case for more aggressive policy easing.

32. The Government's November pre-Budget Report did feature some fiscal relaxation but it also highlighted the very poor health of public sector finances. The size of the package is considered insufficient to kick-start the economy. The onus for economic stimulation will fall upon monetary policy and the Bank of England.

33. The Bank will continue to ease policy and the need to drive commercial interest rates, currently underpinned by the illiquidity of the money market, to much lower levels suggests the approach will be more aggressive than might otherwise have been the case. A Bank Rate of 1% now seems a distinct possibility and short-term LIBOR rates of below 2% may result. Only when the markets return to some semblance of normality will official rates be edged higher.

34. Long-term interest rates will be the victim of conflicting forces. The threat of deep global recession should drive bond yields to yet lower levels and this will be a favourable influence upon the sterling bond markets. But the prospect of exceptionally heavy gilt-edged issuance in the next three years (totalling in excess of £100bn per annum), as the Government seeks to finance its enormous deficit, could severely limit the downside potential for yields.

Sensitivity to Interest Rate Movements

35. Future Council accounts will be required to disclose the impact of risks on the Council's treasury management activity. Whilst most of the risks facing the treasury management service are addressed elsewhere in this report (credit risk, liquidity risk, market risk, maturity profile risk), the impact of interest rate risk is discussed but not quantified. The table below highlights the estimated impact of a 1% increase/decrease in all interest rates to treasury management income for next year. That element of the investment portfolio which is of a longer term, fixed interest rate nature will not be affected by interest rate changes.

Table 9: Sensitivity to Interest Rate Movements		
Revenue Budgets	**2009/10 Estimated + 1% £'000**	**2009/10 Estimated - 1% £'000**
Investment income	419	-470

Treasury Strategy 2009/10 – 2011/12

36. The uncertainty over the UK economy and the level of confidence in individual banks increases the risks associated with treasury activity. As a result the Council will take a cautious approach to its treasury strategy and leave the target for investment returns unchanged at 0.1% over the 7 day LIBID rate for 2009/10, 2010/11 and 2011/12.

37. Long-term fixed interest rates are at risk of being higher over the medium term. The Director of Finance & ICT, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above. It is likely that shorter term fixed rates may provide better opportunities.

Investment Counterparty and Liquidity Framework

38. The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

- 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.

39. The Director of Finance & ICT will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. This criteria is separate to that which chooses Specified and Non-Specified investments as it selects which counterparties the Council will invest with rather than defining what form its investments will take. The rating criteria (see explanation of the credit ratings in Appendix 17a) use the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria.

- **Banks and Building Societies** – the Council will invest in banks and building societies which have the following Fitch or equivalent ratings as a minimum:
  - **Short Term** – F1 (minimum of F1+ for total investments between £5m to £10m)
  - **Long Term** – A (minimum of AA- for total investments between £5m and £10m)
  - **Individual / Financial Strength** – C (Fitch / Moody's only)
  - **Support** – 3 (Fitch only)
- **Building Societies with credit ratings** – the Council will invest in building societies based in either the United Kingdom or the Republic of Ireland, provided that these have a credit rating as specified above.

  The Council will no longer invest with unrated societies.
- **Money Market Funds** – AAA
- **UK Government** including gilts and the Debt Management Account Activity Deposit Facility (DMADF – a Government body which accepts local authority deposits)
- **Local Authorities, Parish Councils etc**

40. The time limits for institutions on the Council's counterparty list are five years, unless shorter time limits are specified above (these will cover both specified and non-specified Investments). Investments for terms of one year or more are subject to prior approval by the Director of Finance & ICT. The proposed criteria for specified and non-specified investments are shown in paragraphs 52 to 58 for approval.

41. The use of longer term instruments (one year or greater from inception to repayment) will fall into the category of non-specified investments. These instruments will be used only where the Council's liquidity requirements are safeguarded. This usage is limited by Prudential Indicator 17 at paragraph 43 below.

Investment Strategy 2009/10 – 2011/12

Treasury Management Prudential Indicators and Limits on Activity

42. There are four more treasury prudential indicators. The purpose of these prudential indicators is 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. The indicators are:

- Upper limits on fixed interest rate exposure (Prudential Indicator 14). This indicator identifies a maximum limit for fixed interest rates based upon the debt position net of investments
- Upper limits on variable interest rate exposure (Prudential Indicator 15). Similar to the previous indicator, this covers a maximum limit on variable interest rates.
- Maturity structures of borrowing (Prudential Indicator 16). These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing; upper and lower limits of each category are required.
- Total principal funds invested for one year or more (Prudential Indicator 17). These limits are set to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

43. **Members are recommended to approve the contents of Tables 10 and 11 as Prudential Indicators 14, 15, 16 and 17.**

Table 10: Exposure to fixed/variable interest rates (Prudential Indicators 14 and 15)

	2009/10 Upper	2010/11 Upper	2011/12 Upper
Limits on fixed interest rates	100%	100%	100%
Limits on variable interest rates	30%	30%	30%

Table 11: Maturity structure of fixed interest rate borrowing and limits on longer term investments (Prudential Indicators 16 and 17)

	2009/10		2010/11		2011/12	
Borrowing	**Lower**	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	0%	100%	0%	100%	0%	100%
12 months to 2 years	0%	0%	0%	0%	0%	0%
2 years to 5 years	0%	0%	0%	0%	0%	0%
5 years to 10 years	0%	0%	0%	0%	0%	0%
10 years and above	0%	0%	0%	0%	0%	0%
Maximum principal sums invested > 364 days	£30 m		£30 m		£30 m	

Performance Indicators

44. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. As a debt free council with no externally managed funds, the only effective performance indicator that can be set is an achievement margin in excess of the 7 day LIBID rate, the London Interbank Bid rate, which is the generally accepted benchmark for local authority treasury operations. The results of these indicators will be reported in the Treasury Annual Report for 2008/09.

45. **Members are recommended to approve the local performance indicators set out in Table 12.**

Table 12: Performance indicator for the Council's Treasury operations			
	2009/10 %	**2010/11 %**	**2011/12 %**
Returns to exceed the 7 Day LIBID rate by:	0.10	0.10	0.10

Treasury Management Practice (TMP) 1 (5) – Credit and Counterparty Risk Management

46. The Office of the Deputy Prime Minister (now the CLG) issued Investment Guidance on 12th March 2004, and this forms the structure of the Council's policy below.

47. The key intention of the Guidance was to maintain the current requirement for Councils to invest prudently, giving priority to security before liquidity, before yield. In order to facilitate this objective, the guidance requires this Council to have regard to the CIPFA publication "Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes". This Council adopted the Code on 18 April 2002 and will continue to apply its principles to all investment activity. In accordance with the Code, the Director of Finance & ICT has produced treasury management practices. This part, TMP 1(5), covering investment counterparty policy requires approval each year.

48. 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, to be approved by full Council and covering the identification and approval of:

    - 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 Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
    - Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

49. Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of the current 1.5% Bank Rate reducing throughout 2009 and into 2010. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts.

50. There is a clear operational difficulty arising from the current banking crisis. Ideally investments would be invested longer to secure better returns, however uncertainty over counterparty creditworthiness suggests shorter dated investments would provide better security.

51. The criteria for choosing counterparties set out above provide a sound approach to investment in "normal" market circumstances. Whilst Members are asked to approve this base criteria above, under the exceptional current market conditions the Director of Finance & ICT will temporarily restrict further investment activity to those counterparties with a credit rating from Fitch of AA- or above and limit investment to a maximum of 3 months. These restrictions will remain in place until the banking system returns to "normal" conditions.

Specified and Non-Specified Investments

52. Specified investments are sterling investments with original investment terms of not more than one year, or those which are agreed for a longer period where the Council has the right to be repaid within 12 months if it wishes. These are low risk assets where the possibility of loss of principal or investment income is small. These include investments with:

I The UK Government (such as the DMADF, UK Treasury Bills or a Gilt with less than one year to maturity).

II A local authority, parish council or community council.

III Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency.

IV A financial body such as a bank or building society that has been awarded a high credit rating by a credit rating agency.

V A financial body which has been provided with a government issued guarantee for wholesale deposits within specific timeframes.

53. The Council proposes to invest in specified investments, with further restrictions related to credit ratings.

54. **Members are requested to confirm their approval of the following specified investments for this council:**

- **All Category I, II and V investments;**
- **For Category III - money market funds rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.**
- **For Category IV - bodies with a minimum short term rating of A-1, P-1 and F1 as rated by Standard and Poor's, Moody's or Fitch rating agencies respectively.**

55 Non-specified investments are any other type of investment (i.e. not defined as specified above). These would include sterling investments with:

I. Securities which are guaranteed by the UK Government (such as supranational bonds). These are fixed income bonds although the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.

II. Gilt edged securities with a maturity of greater than one year.

III. Institutions not meeting the basic security requirements under the specified investments.

IV. A body that has been awarded a high credit rating by a credit rating agency (such as a bank or building society), for deposits with a maturity of greater than one year.

56 Proposals approved at Cabinet in December 2004 added the thirty largest building societies by capital asset base to the counterparty listing. A review of the counterparty criteria in August 2007 introduced limits on investments in unrated societies determined by their asset base. In the current climate it is no longer felt prudent to invest with unrated societies. The Council will now only deal with building societies that satisfy the minimum rating requirements set out above.

57 Proposals approved at Cabinet in December 2004 also allow a limited proportion of funds to be invested for terms of between one and five years. On the advice of Butlers, any investment of a term of one year or more would be made only with a counterparty possessing a minimum long term credit rating of A- (Fitch), A3 (Moody's) and A (Standard & Poors).

58 **Members are requested to confirm that, for the time being, it is intended that non-specified investments will not form part of the Council's investment portfolio, with the exception of;**

- **A maximum of £30,000,000 invested for terms of one year or more, subject to the credit rating criteria in Paragraph 57 and a maximum term of five years.**

59 The credit rating of counterparties will be monitored regularly. The Council receives credit rating emails from its Treasury advisers as and when ratings change, and counterparties are checked promptly on receipt of these emails. Any counterparty failing to meet the criteria will be removed from the list immediately by the Director of Finance & ICT and new counterparties which meet the criteria will be added to the list.

60 The Council is aware that a counterparty may hold investments from the Council at the time that it is removed from the approved list due to a downgraded rating. The criteria used are high enough that a minor downgrading should not affect the full receipt of the principal and interest at maturity. Existing investments with the downgraded counterparty will therefore be allowed to run to maturity, unless there is reason to believe that an attempt should be made to retrieve the funds beforehand.

61 It should be noted that credit ratings are subject to change without prior warning, and that a high credit rating is an indication, not a guarantee, of a financial body's stability and creditworthiness.

62 The Council is aware that external fund managers are potentially able to achieve higher returns on an investment portfolio than in-house staff. However, these potential high returns are offset by the managers' fees. The Council has considered the net returns available through the use of external managers, and has decided to retain its policy of retaining the entire portfolio in-house. This policy will be kept under review each year.

Table 13: Returns achieved by the in-house Treasury team compared to the industry average net returns for external fund management teams

	2005/06 %	**2006/07 %**	**2007/08 %**
In-house team	4.73%	4.92%	5.85%
External management (net of charges)	4.60%	4.29%	5.86%
Average 7 Day LIBID	4.53%	4.82%	5.59%

Annex 17a

Credit Ratings

Long-Term Credit Ratings

Long-term credit ratings are set up along a scale from 'AAA' to 'D', and adopted and licensed by Standard and Poor (S&P). Moody's also uses a similar scale, but names the categories differently. Like S&P, Fitch also uses intermediate modifiers for each category between AA and CCC (i.e., AA+, AA, AA-, BBB+, BBB, BBB- etc.). Moodys intermediate modifers for each category between Aa to Caa are Aa1, Aa2, Aa3, A1, A2 etc.

Definitions	**Fitch**	**Moody**	**Standard & Poor**
The best quality institutions, reliable & stable	AAA	Aaa	AAA
Quality institutions, slightly higher risk than AAA	AA	Aa	AA
Economic situation can affect finance	A	A	A
Medium class institutions, which are satisfactory at the moment	BBB	Baa	BBB

Short-Term Credit Ratings

Short-term ratings indicate the potential level of default within a 12-month period.

Definitions	**Fitch**	**Moody**	**Standard & Poor**
Best quality grade, indicating exceptionally strong capacity of obligor to meet its financial commitment	F1+	P-1	A-1+
Best quality grade, indicating strong capacity of obligor to meet its financial commitment	F1	P-2	A-1
Good quality grade with satisfactory capacity of obligor to meet its financial commitment	F2	P-3	A-2
Fair quality grade with adequate capacity of obligor to meet its financial commitment, but near term adverse conditions could impact the obligor's commitments	F3		A-3