COUNCIL
26 FEBRUARY 2009

ITEM NO. 3 (b)

PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT STRATEGY REPORT 2009/10

Responsible Cabinet Member - Councillor Stephen Harker, Resources Portfolio

Responsible Director - Paul Wildsmith, Director of Corporate Services

---

SUMMARY REPORT

Purpose of the Report

1. This report requests the Council to review and adopt: -

   (a) Prudential indicators and limits relating to capital expenditure and Treasury Management activity
   (b) A policy Statement relating to Minimum Revenue Provision, and
   (c) The Treasury Management Strategy 2009/10, which includes the Investment Strategy for 2009/10

Summary

2. "The Prudential Code for Capital Finance" ("the Code") was introduced in 2004, when local authorities were given extra freedoms to borrow without central government approval. The Code uses Prudential Indicators and limits on borrowing activity to ensure that Councils' capital expenditure and financing decisions are prudent and affordable. Under the Code, the Council is required to approve three reports each year, one before the start of the year, one mid-year and one at the end of the year.

3. This report sets out the proposed capital expenditure, borrowing and investment activity for 2009/10 to 2011/12. The report contains Prudential Indicators that relate to capital expenditure and borrowing. Other statistics relating to treasury management are also included.

4. The information contained in the report regarding the Council's capital expenditure plans, Treasury Management and Prudential Borrowing activities indicates that they are: -

   (a) Within the statutory framework and consistent with the relevant codes of practice.
   (b) Prudent, affordable and sustainable.
   (c) An integral part of the Council's Revenue and Capital Medium Term Financial Plans.

5. A summary of the key prudential indicators and limits are contained in **Tables 1** and **2** below.

Table 1 – Capital Expenditure and Borrowing

	2008/09 Revised	**2009/10 Estimated**	**2010/11 Estimated**	**2011/12 Estimated**
	£m	£m	£m	£m
Capital Expenditure	62.388	34.890	32.495	19.211
Capital financing requirement	111.360	118.918	120.101	118.868
Operational boundary for external debt	113.360	120.918	122.101	120.868
Authorised limit for external debt	124.638	133.010	134.311	132.955
Ratio of financing costs to net revenue stream – General Fund	1.60%	3.11%	3.35%	3.50%
Ratio of financing costs to net revenue stream – HRA	9.60%	12.49%	13.78%	13.54%
Incremental impact of **new** capital investment decisions on the band D Council Tax		£0.66	£3.03	£2.97
Incremental impact of **new** capital investment decisions on Housing Rents levels		Nil	Nil	Nil

Table 2 – Treasury Management

	2009/10 Upper Limit	2010/11 Upper Limit	2011/12 Upper Limit
Limits on fixed interest rates	100%	100%	100%
Limits on variable interest rates	40%	40%	40%
Maturity Structure of fixed interest rate borrowing			
	Upper Limit	**Upper Limit**	**Upper Limit**
Under 12 months	25%	25%	25%
12 months to 2 years	40%	40%	40%
2 years to 5 years	60%	60%	60%
5 years to 10 years	80%	80%	80%
10 years and above	100%	100%	100%
Maximum principal sums invested > 364 days	£15M	£15M	£15M

Recommendation

6. It is recommended that Council: -

   (a) Adopt the prudential indicators and limits for 2009/10 to 2011/12 contained within this report in **Tables 3 to 10 and 12 to 14**

   (b) Approve the Minimum Revenue Provision (MRP) Policy Statement contained in paragraph 22

   (c) Approve the Treasury Management Strategy 2009/10 contained in paragraphs 36 to 64.

   (d) Approve the Investment Strategy 2009/10 contained in the Treasury Management Strategy, and the detailed criteria included in **Appendix 3**, specifically approving the criteria for specified investments and the criteria for non-specified investments.

Reasons

7. The recommendations are supported by the following reasons: -

   (a) In order to comply with the Prudential Code for Capital Finance in Local Authorities and Department for Communities and Local Government (CLG) guidance on investments.

   (b) To comply with the requirements of the Local Government Act 2003.

   (c) To approve a framework for Officers to work within when making investment decisions.

Paul Wildsmith
Director of Corporate Services

Background Papers

CIPFA The Prudential Code for
Capital Finance in Local Authorities
Annual Statement of Accounts 2007/08
Draft Capital MTFP 2009/10-2011/12

Elaine Hufford : Extension 2447

S17 Crime and Disorder	This report has no implications for S17 Crime and Disorder
Health and Well Being	This report has no implications for the Councils Health and Well Being agenda
Sustainability	This report has no implications for the Councils Sustainability agenda
Diversity	This report has no implications for the Councils Diversity agenda
Wards Affected	All wards
Groups Affected	All groups
Budget and Policy Framework	This report must be considered by Council
Key Decision	This is a key decision
Urgent Decision	This report will be considered by Council along with the Medium Term Corporate Plan on26 February 2009
One Darlington: Perfectly Placed	This report has no particular implications for the Sustainable Community Strategy

MAIN REPORT

Information and Analysis

8. This report covers the operation of the Council's prudential indicators, its Treasury Management function and its likely activities for the forthcoming year. The report incorporates four key Council reporting requirements: -

   (a) The reporting of prudential indicators in accordance with the requirements of the CIPFA Prudential Code for Capital Finance in Local Authorities with detailed analysis in **Appendix 1**.

   (b) A Policy Statement relating to provision in the revenue account for debt repayment

   (c) The Treasury Management Strategy for 2009/10 in accordance with the CIPFA Code of Practice on Treasury Management incorporating the summary of the Investment Strategy (in accordance with the Department of Communities and Local Government (CLG) investment guidance). It also includes specific treasury management prudential indicators.

   (d) The detailed investment criteria contained in **Appendix 3**.

9. This budgetary cycle provides for the sixth full year of the operation of the CIPFA Prudential Code. The Prudential Code operates by the provision of prudential indicators, which highlight aspects of the capital expenditure planning. Each indicator provided during the 2008/09 budget process has been updated and provided for the next three years. These are detailed below. This is in accordance with the Prudential Code, which requires that Council approve certain mandatory indicators.

10. The purpose of the indicators is to provide a framework for capital expenditure decision-making. The prudential indicators highlight the level of capital expenditure; the impact on borrowing and investment levels and the overall controls in place to ensure the activity remains affordable, prudent and sustainable.

11. Capital expenditure decisions impact on the Council's treasury management activity, either through increased borrowing levels or the application of investment balances. Consequently the Treasury Management Strategy for 2009/10 is included in this report. This report also includes the Treasury Management Prudential Indicators. The production of the Treasury Management Strategy is a requirement of the CIPFA Code of Practice on Treasury Management.

12. In addition, part of the Treasury Management Strategy requirements is the formulation of an investment strategy. Investment guidance issued by the CLG during March 2004 overlaps into the Code of Practice requirements. The reporting requirements of the CLG guidance have therefore been incorporated into the Treasury Management Strategy.

CAPITAL EXPENDITURE, THE CAPITAL FINANCING REQUIREMENT AND ASSOCIATED PRUDENTIAL INDICATORS

Capital Expenditure

13. The Council's capital expenditure plans will be partially financed by resources such as capital grants and capital contributions. The remaining element, which cannot be immediately financed from other sources, will impact on the Council's underlying need to borrow, called the Capital Financing Requirement (CFR). The summary of capital expenditure financing and the impact on the CFR are show in **Tables 3 and 4** below. The figures included in these tables represent the forecasted capital programme in Appendix 10 of the Draft Corporate Medium Term Financial Plan adjusted for any slippage from previous years plus the proposed Corporate Capital Programme This forms one of the required prudential indicators. A more detailed analysis, breaking down the General Fund and the Housing Revenue Account split is shown in **Appendix 1.**

14. A certain level of borrowing will be supported by the Government through the Revenue Support Grant. Any borrowing above this level will be unsupported and will need to be financed from the Council's own resources.

15. The limiting factors on the Council's ability to undertake unsupported capital expenditure is the availability of

    (a) Revenue resources to support in full the implications of capital expenditure, both borrowing and ongoing running costs. i.e. Can the Council afford the implications of the unsupported borrowing?

    (b) The Government has reserve powers to implement specific limit on Council's capital expenditure plans. No such limits were implemented in the past four years and there is no indication of such controls for 2009/10.

16. A risk of the plan is that the level of government support has some estimates in for 2009/10 and 2010/11 and is therefore subject to change. Similarly some of the estimates for other sources of funding such as capital receipts may be subject to change over this timescale. The Council reviews and adjusts its capital expenditure plans annually, taking account of changes in projected future years' resources. Anticipated asset sales will be postponed due to the impact of the recession on the property market.

17. The Council is asked to approve the capital expenditure projections below. Service details are in **Appendix 1** and further details of Capital expenditure are contained in the Capital MTFP report. This forms the first prudential indicator.

Table 3

	2008/09 Revised	2009/10 Estimate	2010/11 Estimate	2011/12 Estimate
	£m	£m	£m	£m
Capital Expenditure				
Total Expenditure	**62.388**	**34.890**	**32.495**	**19.211**
Financed by				
Capital Receipts	2.492	0.360	0.450	0.450
Capital Grants	37.550	20.905	24.680	13.483
Capital Contributions	3.322	0.010	-	-
Revenue	2.822	2.189	1.826	1.976
Total Financing other than borrowing	46.186	23.464	26.956	15.909
Net financing need for the year	16.202	11.426	5.539	3.302

Minimum Revenue Provision Policy Statement

18. The Council is required to charge to its revenue account each year a provision to pay off an element of the accumulated General Fund capital debt (the Minimum Revenue Provision - MRP). The Council may also make additional voluntary revenue provision (VRP) to further reduce the CFR.

19. CLG regulations require the Council to approve an MRP Policy Statement. This will need to be approved in advance of each year. Whilst the regulations revoke current MRP requirements, Councils are allowed to continue historical accounting practice for all capital borrowing incurred prior to 1st April 2008. However, in order to ensure that Local Authorities prudently repay debt incurred in later years, this method of calculation for MRP will only relate to supported capital expenditure that is funded through Revenue Support Grant. Debt that is incurred for unsupported borrowing will have to be repaid over the life of the asset to which the capital expenditure relates. For both types of future capital expenditure there are 2 options.

20. For capital expenditure incurred before 1st April 2008 and future expenditure supported through the Revenue Support Grant the 2 options are:

    (a) Existing Practice- MRP will follow the existing practice outlined in the former CLG Regulations. This method is based on 4% of the opening balance sheet non-housing CFR but allows for adjustments to the calculation based on figures prior to the implementation of the prudential code.

    (b) Based on CFR - MRP will be based on 4% of the opening balance sheet non-housing CFR, without adjustments.

21. From 1st April 2008 for all unsupported borrowing the MRP options are:

    (a) Asset Life Method – MRP will be based on the estimated life of the assets in accordance with the proposed regulations. This option must be applied for any expenditure capitalised under a Capitalisation Directive. These are items that would normally be classified as revenue but are allowed to be financed by capital resources.

(b) Depreciation Method - MRP will follow standard depreciation accounting procedures usually on a straight line method or reducing balance.

22. It is proposed that Darlington Borough Councils MRP Policy will be

(a) For capital expenditure incurred before 1st April 2008 and future expenditure supported through the Revenue Support Grant -

Existing Practice as outlined in paragraph 20 (a) will be used.

(b) From 1st April 2008 for all unsupported borrowing -

The MRP will follow the Asset Life Method as outlined in Paragraph 21 (a).

23. This policy will give the Council the most flexibility when calculating MRP. Additional repayments of debt will always be available should the Council so wish in the form of Voluntary Revenue Payments.

24. Having regard to capital expenditure plans and MRP / VRP, the Council is asked to approve the CFR projections below: -

Table 4

	2008/09 Revised	**2009/10 Estimate**	**2010/11 Estimate**	**2011/12 Estimate**
	£m	**£m**	**£m**	**£m**
Capital Financing Requirement				
CFR – General Fund	77.356	81.706	82.165	81.143
CFR – Housing	34.004	37.212	37.936	37.725
Total CFR	**111.360**	**118.918**	**120.101**	**118.868**
Net movement in CFR	13.216	7.558	1.183	-1.233
Movement in the CFR represented by				
Net financing need for the year from Table 3	16.202	11.426	5.539	3.302
MRP/VRP and other financing movements	-2.986	-3.868	-4.356	-4.535
Movement in CFR	13.216	7.558	1.183	-1.233

25. The expected impact of the capital expenditure decisions on the Council's debt and investment position are shown below.

Limits to Borrowing Activity

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

27. For the first of these the Council needs to ensure that its total borrowing net of any investments does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2008/09 and next two financial years. This allows some flexibility for limited early borrowing for future years.

Table 5

	2008/09 Revised	2009/10 Estimate	2010/11 Estimate	2011/12 Estimate
	£m	£m	£m	£m
Gross Borrowing	111.360	118.918	120.101	118.868
Investments	47.915	42.350	41.475	41.475
Net Borrowing	63.445	76.568	78.626	76.993
CFR (from Table 4)	111.360	118.918	120.101	118.868

28. The Council will comply with the prudential indicator requirement to keep net borrowing below the relevant CFR in the current year, and the above table confirms that no difficulties are envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the Revenue and Capital Medium Term Financial Plans.

29. A further two prudential indicators control the overall level of borrowing. These are:

(a) **The Operational Boundary –** This indicator is based on the probable external debt during the course of the year; it is not a limit and actual borrowing could vary around this boundary for short times during the year. It should act as an indicator to ensure the authorised limit is not breached.

(b) **The Authorised Limit –** This represents the limit beyond which borrowing is prohibited, and this limit needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

30. The Council is asked to approve the following operational and authorised limits.

Table 6

	2008/09 Revised	2009/10 Estimate	2010/11 Estimate	2011/12 Estimate
Operational Boundary	**£m**	**£m**	**£m**	**£m**
Borrowing as per Capital MTFP	111.360	118.918	120.101	118.868
Estimated additional supported borrowing	0.500	0.500	0.500	0.500
Prudential Borrowing to cover leasable assets	1.000	1.000	1.000	1.000
Possible Prudential Borrowing under Directors delegated powers	0.500	0.500	0.500	0.500
Operational Boundary	**113.360**	**120.918**	**122.101**	**120.868**
Additional Headroom as a % of Operational Boundary for External Debt		10%	10%	10%
Authorised Limit	**124.638**	**133.010**	**134.311**	**132.955**

Affordability Prudential Indicators

31. The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the overall Council finances. The Council is asked to approve the following indicators:

32. **Actual and Estimates of the ratio of financing costs to net revenue stream –** This indicator identifies the trend in the cost of capital (borrowing costs net of investment income) as a percentage of the net revenue budget, both for the General Fund and the Housing Revenue Account.

Table 7 - Ratio of financing costs to net revenue stream

	2008/09 Revised	2009/10 Estimate	2010/11 Estimate	2011/12 Estimate
General Fund	**1.60%**	**3.11%**	**3.35%**	**3.50%**
HRA	**9.60%**	**12.49%**	**13.78%**	**13.54%**

33. The estimates of financing costs include current commitments and the proposals in Revenue and Capital MTFP reports.

34. **Estimates of the incremental impact of capital investment decisions on the Council Tax** - This indicator identifies the trend in the cost of proposed changes in the three year capital programme recommended in this budget report compared to the Council's existing commitments and current plans, and therefore relates to ***new schemes*** within this MTFP round. The Corporate Medium Term Financial Plan proposes new schemes amounting to £1.165M for 2009/10 only, to be paid using corporate prudential borrowing, the incremental impact of that proposal on Council Tax Band D is shown below. In addition to that there may also be some departmental unsupported borrowing to be undertaken in the form of 'invest to save' schemes and replacing leased assets i.e. computer equipment with assets paid for by prudential borrowing, the repayment of this borrowing will be accommodated within Departmental resource allocations, which will therefore have no incremental effect on Council Tax.

Table 8 – Incremental impact of *new* capital investment decisions on the Band D Council Tax

	Proposed Budget 2009/10 £	Forward Projection 2010/11 £	Forward Projection 2011/12 £
Incremental impact of **new** capital investment decisions on the Band D Council Tax.	**£0.66**	**£3.03**	**£2.97**

35. **Estimates of the incremental impact of capital investment decisions on Housing Rent levels** – Similar to the Council tax calculation this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in this budget report, compared to the Council's existing commitments and current plans, expressed as a change in weekly rent levels. In July 2004 Council approved a decision to prudentially borrow up to £20m over six years to invest in Council Housing in order to meet the Decent Homes Standard. However, the additional repayment costs of the debt incurred are to be accommodated within the Housing Revenue Account resources, the increased financing charges will be compensated by a reduction in other management costs, therefore, there is to be no incremental effect on housing rent levels.

Table 9 – Incremental impact of capital investment decisions Housing Rent levels

	Revised 2008/09 £	Proposed Budget 2009/10 £	Forward Projection 2010/11 £	Forward Projection 2011/12 £
Weekly Housing Rents	**Nil**	**Nil**	**Nil**	**Nil**

TREASURY MANAGEMENT STRATEGY 200910 – 2011/12 INCLUDING THE TREASURY MANAGEMENT PRUDENTIAL INDICATORS AND LIMITS ON ACTIVITY.

36. The Treasury Management service is an important part of the overall financial management of the Council's affairs. Its importance has increased as a result of the freedoms provided by the Code. It covers the borrowing and investment activities and the effective

management of associated risks. Whilst the prudential indicators above consider the affordability and impact of capital expenditure decisions, the treasury management service covers the effective funding of these decisions. There are also specific treasury management prudential indicators included in this strategy which need approval.

37. The Council's 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 21st March 2002 (Min. Ref. 63/Mar/2002 refers), and as a result adopted a Treasury Management Policy Statement. This adoption meets the requirements of the first of the Treasury Management prudential indicators and so the Council consistently and continually complies with this indicator.

38. The Treasury Management Policy requires an annual strategy to be reported to Cabinet/Council outlining the expected treasury activity for the forthcoming 3 years. Two further reports are produced, one mid-year reporting on activity part way through the year and the other after the year-end to report on actual activity for the year.

39. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the Treasury Management service.

40. This strategy covers:

(a) The Council's debt and investment projections.
(b) The expected movement in interest rates.
(c) The Council's borrowing and investment strategies.
(d) Treasury Management performance indicators.
(e) Specific limits on Treasury Management activities.
(f) Any local Treasury Management issues.

Debt and Investment Projections 2008/09 – 2010/11

41. The borrowing requirement comprises the expected movement in the CFR and any maturing debt, which will need to be refinanced. The table below shows this effect on the treasury position over the next three years. It also highlights the expected change in investment balances.

Table 10

	2008/09 Revised £m	**2009/10 Estimate £m**	**2010/11 Estimate £m**	**2011/12 Estimate £m**
External Debt				
Debt at 1st April	101.242	111.360	118.918	120.101
Expected change in debt	10.118	7.558	1.183	-1.233
Debt at 31st March	111.360	118.918	120.101	118.868
Investments				
Total Investments at 31st March	47.915	42.350	41.475	41.475
Investment Change	4.455	-.5.565	-0.875	-

Expected Movement in Interest Rates

42. There is always a risk to the Treasury Management Budget from further adverse move in interest rates. The Prudential code is constructed on the basis of affordability, part of which relates to borrowing costs and investment returns. The Council employs Butlers, the treasury consultants , to advise on the Treasury management Strategy, to provide economic data and interest rate forecasts, to assist planning and reduce unforeseen adverse movements. Butlers' view of the UK and world economy and the effects this will have on UK interest rates is attached at **Appendix 2**. Forecast rates are summarised in Table 11.

Table 11
Medium term rate forecasts – Annual Average %(Source Butlers)

Year	Bank Rate	Investment Rates		PWLB Rates*		
		3 Month	1 Year	5 year	20 year	50 year
2008/09	3.9	5.0	5.3	4.2	4.8	4.5
2009/10	1.2	1.8	2.0	2.1	3.9	3.8
2010/11	1.9	2.3	3.0	3.2	4.1	4.0
2011/12	2.6	3.0	3.8	4.0	4.3	4.1

*Borrowing Rates

Borrowing and Debt Strategy 2009/10 – 2011/12

43. The uncertainty over future interest rates increases the risks associated with the Treasury Management Strategy. As a result the Council will continue to take a cautious approach to its Treasury Management Strategy.

44. Long-term fixed interest rates are expected to increase in the next 2-3 years. The Director of Corporate Services, 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. This may include borrowing in advance of future years requirements.

45. Interest rate forecasts mean that debt restructuring is likely to focus on switching from longer term fixed interest rates to cheaper short term debt, although the Director of Corporate Services and treasury consultants will monitor prevailing rates for any opportunities during the year.

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

47. During 2009/10 it is expected that the Council will need to borrow an additional £11.426M to cover part of its Capital Programme, see **Table 3,** and of this £4.697M will be supported by the Revenue Support Grant. Although £3.740M will be unsupported for Housing Revenue Account this has already been approved by Council. However, after taking account the statutory MRP and VRP of £3.868M it is expected that borrowing will rise by £7.558 M.

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

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

(b) It maintains a policy covering both 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 in **Appendix 3** for approval.

49. The Director of Corporate Services will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit it to the Council for approval as necessary. This criteria is separate to that which chooses Specified and Non-Specified as it selects which counterparties the Council will choose rather than defining what its investments are. The rating criteria use the lowest common denominator method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Councils Criteria the other does not, the institution will fall outside the lending criteria.

50. In accordance with the report to Cabinet in November 2008 the Council will restrict its counterparty list to UK banks and building societies,

(a) Banks (1) – the Council will use banks which have at least the following Fitch, Moody's and Standard and Poors Rating (where rated)
   (i) Short Term F1
   (ii) Long Term A-
   (iii) Individual/ Financial Strength C (Fitch/ Moodys only)
   (iv) Support 3 (Fitch only)

(b) Banks (2) In addition the Council will use banks whose ratings fall below the criteria specified above if all of the following conditions are met, Banks in this category would include, for example Northern Rock.
   i) Wholesale deposits in the bank are covered by a government guarantee
   ii) The Council's investments with the bank are limited to amounts and maturities within the terms of the stipulated guarantee.

(c) Building Societies the – Council will use Building Societies with assets in excess of £1000M
(d) AAA rated Money Market Funds
(e) UK Government including the Debt Management Office
(f) Council's and other Public Authorities

51. The time limits for institutions on the Council's Counterparty list are as follows (these will cover both Specified and Non- Specified Investments)

Table 12

	Fitch	Moodys	Standard and Poors	Money Limit	Time Limit
Upper LimitCategory	**AAA**	**Aaa**	**AAA**	**£5M**	**5 years**
Middle Limit Category	**AA-**	**Aa3**	**AA-**	**£5M**	**4 years**
Lower Limit Category	**A-**	**A3**	**A-**	**£3M**	**2 years**
Debt Management Office	**-**	**-**	**-**	**Unlimited**	**1 Year**
Local Authorities	**-**	**-**	**-**	**£5M**	**1 year**
Unrated Building Societies Asset Base > £1Billion	**-**	**-**	**-**	**£2M**	**6months**
Guaranteed Organisations	**-**	**-**	**-**	**£3M**	**3months**

52. The proposed criteria for Specified and Non-specified investments is shown in Appendix 3

53. In the normal course of the Council's cashflow 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.

54. The use of longer term investments (greater than one year from inception to repayment) will fall in the Non-specified investment category. These instruments will only be used where the Council's liquidity requirements are safeguarded. This will also be limited by the investment prudential indicator in **Table 14**

Investment Strategy 2009/10-2011/12

55. Expectations on shorter- term interest rates, on investment decisions are based, show a likelihood of the current 2.0% Bank rate reducing throughout 2009 and into 2010. The Council's investment decisions are based on comparisons between the rises priced into market rates and the Council's and advisors own forecasts.

56. There is a clear operational difficulty arising from the current banking crisis. Ideally investments would be invested longer to secure better returns. Uncertainty over counterparty credit worthiness, however suggests shorter dated investments would provide better security, and this would include money market funds which can be recalled without notice.

57. 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 Corporate Services will 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.

58. Examples of these restrictions would be the greater use of the Debt Management Deposit 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.

Sensitivity to Interest Rate Movements

59. 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, and maturity profile risk), the impact of interest rate risk has been discussed but not quantified. The table below highlights the estimated impact of a 1% increase/ decrease in all interest rates to treasury management costs/income for next year.

Table 13

	2009/10 Estimated +1% £m	2009/10 Estimated -1% £m
Revenue Budgets		
New Debt Interest on Borrowing	0.058	-0.058
Related HRA Charge	0.018	-0.018
Net General Fund Borrowing Cost	0.040	-0.040
Investment Income	-0.342	0.342

Treasury Management Prudential Indicators and Limits on Activity

60. There are four further Treasury Management Prudential Indicators. The purpose of these prudential indicators is to contain the activity of the Treasury Management 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:

(a) Upper limits on fixed rate exposure – This indicator identifies a maximum limit for fixed interest rates based upon the debt position net of investments.

(b) Upper limits on variable rate exposure – Similar to the previous indicator this covers a maximum limit on variable interest rates based upon the debt position net of investments.

(c) Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing in any one year, both upper and lower limits are required by the Code.

(d) Total principal funds invested for greater than 364 days – These limits are set to reduce the need for early sale of an investment, and are based on the availability of investments after each year-end.

61. The Council is asked to approve the following prudential indicators:-

Table 14

	2009/10		2010/11		2011/12	
	Upper		Upper		Upper	
Limits on fixed interest rates	**100%**		**100%**		**100%**	
Limits on variable interest rates	**40%**		**40%**		**40%**	
Maturity Structure of fixed interest rate borrowing						
	Lower	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	**0%**	**25%**	**0%**	**25%**	**0%**	**25%**
12 months to 2 years	**0%**	**40%**	**0%**	**40%**	**0%**	**40%**
2 years to 5 years	**0%**	**60%**	**0%**	**60%**	**0%**	**60%**
5 years to 10 years	**0%**	**80%**	**0%**	**80%**	**0%**	**80%**
10 years and above	**0%**	**100%**	**0%**	**100%**	**0%**	**100%**
Maximum principal sums invested greater than 364 days	**£15M**		**£15M**		**£15M**	

62. **Table 15** below shows the maturity profile of debt outstanding at 31st March 2008.

Table 15

Analysis of Loans Maturity	**Actual at 31st March 2008**	
	£m	**%**
Under 12 months	Nil	0.0
12 months to 2 years	Nil	0.0
2 years to 5 years	6.000	5.9
5 years to 10 years	Nil	0.0
10 years and above	95.242	94.1
Total	101.242	100
Variable Debt	Nil	0.0

Performance Indicators

63. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the Treasury Management function over the year. These are distinct historic performance indicators, as opposed to the Prudential Indicators, which are predominantly forward looking. Below are the performance indicators currently used by Darlington Borough Council for its Treasury Management function :-

   (a) **Debt** – Average overall interest rate paid compared with previous years.

   (b) **Investments – Short term** - cashflow investment rate returned against comparative average rates.

   (c) **Investments – Longer term** - capital investment rates returned against comparative average rates.

64. The results of these indicators will be reported in the Treasury Management Half Yearly Review and Annual reports for 2009/10

Outcome of Consultation

65. The issues contained in this report do not require formal consultation. However the Prudential Indicators in this report flow directly from the Medium Term Financial Plan which has been widely consulted upon and considered by Resources Scrutiny Committee.

APPENDIX 1

	CAPITAL EXPENDITURE AND THE SOURCES OF FINANCE					
			2008/09 Revised £m	**2009/10 Estimated £m**	**2010/11 Estimated £m**	**2011/12 Estimated £m**
	Capital Expenditure – General Fund					
1	Supported spend		43.294	21.238	23.860	11.843
2	Unsupported spend		6.610	2.989	0.500	-
3	Total spend	*Lines 1+2*	49.904	24.227	24.360	11.843
	Financed by:					
4	Capital receipts		2.477	-	-	-
5	Capital grants		32.784	16.531	20.245	9.000
6	Capital Contribution		3.322	0.010	-	-
7	Revenue		0.217	-	-	-
8	Total financing	*Lines4 to 7*	38.800	16.541	20.245	9.000
9	Net financing need	*3 - 8*	11.104	7.686	4.115	2.843
	Capital Expenditure – Housing Revenue Account					
10	Supported spend		7.386	6.923	6.711	6.909
11	Unsupported spend		5.098	3.740	1.424	0.459
12	Total spend	*10+11*	12.484	10.663	8.135	7.368
	Financed by:					
13	Capital receipts		0.015	0.360	0.450	0.450
14	Capital grants		4.766	4.374	4.435	4.483
15	Capital Contribution		-	-	-	-
16	Revenue		2.605	2.189	1.826	1.976
17	Total financing	*13 to 16*	7.386	6.923	6.711	6.909
18	Net financing need	*12 - 17*	5.098	3.740	1.424	0.459
	Capital Expenditure – Total					
19	Supported spend	*1+10*	50.680	28.161	30.571	18.752
20	Unsupported spend	*2+11*	11.708	6.729	1.924	0.459
21	Total spend	*19+20*	62.388	34.890	32.495	19.211
	Financed by:					
22	Capital receipts	*4+13*	2.492	0.360	0.450	0.450
23	Capital grants	*5+14*	37.550	20.905	24.680	13.483
24	Capital Contributions	*6+15*	3.322	0.010	-	-
25	Revenue	*7+16*	2.822	2.189	1.826	1.976
26	Total financing	*22 to 25*	46.186	23.464	26.956	15.909
27	**Net financing need**	*21 - 26*	**16.202**	**11.426**	**5.539**	**3.302**

	THE CAPITAL FINANCING REQUIREMENT					
			2008/09 Revised £m	**2009/10 Estimated £m**	**2010/11 Estimated £m**	**2011/12 Estimated £m**
	The Capital Financing Requirement - General Fund					
28	CFR Opening Balance		68.853	77.356	81.706	82.295
29	Net financing need	*9*	11.104	7.686	4.115	2.843
30	Less MRP & VRP		2.601	3.336	3.656	3.865
31	CFR Closing balance	*28 to 30*	77.356	81.706	82.165	81.141
32	Net movement in CFR	*31-28*	8.503	4.350	0.459	-1.024
	The Capital Financing Requirement - HRA					
33	CFR Opening Balance		29.291	34.004	37.212	37.936
34	Net financing need	*18*	5.098	3.740	1.424	0.459
35	Less V RP		0.385	0.532	0.700	0.670
36	CFR Closing balance	*33 to 35*	34.004	37.212	37.936	37.725
37	Net movement in CFR	*36-33*	4.713	3.208	0.724	-0.211
	The Capital Financing Requirement - Total					
38	CFR Opening Balance	*28+33*	98.144	111.360	118.518	120.101
39	Net financing need	*29+34*	16.202	11.426	5.539	3.302
40	MRP & VRP	*30+35*	2.986	-3.868	-4.356	-4.535
41	CFR Closing balance	*38 to 40*	111.360	118.918	120.101	118.868
42	**Net movement in CFR**	*41-38*	**13.216**	**7.558**	**1.183**	**-1.233**

MRP - Minimum Revenue Provision
VRP - Voluntary Revenue Provision

BUTLERS VIEW OF UK AND WORLD ECONOMY AND ITS EFFECT ON UK INTEREST RATES

1. *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.*
2. *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 ease.*
3. *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.*
4. *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.*
5. *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.*

TREASURY MANAGEMENT PRACTICE (TMP)1 (5)- CREDIT AND COUNTERPARTY RISK MANAGEMENT

1. The Office of the Deputy Prime Minister (now CLG) issued investment guidance on 12th March 2004, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds, which are regulated by a different regulatory regime.

2. The key intention of the Guidance is to maintain the current requirement for Councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council adopted the Code on 21st March 2002 (Min. Ref. 63/Mar/2002 refers) and will apply its principles to all investment activity. In accordance with the Code, the Director of Corporate Services has produced its Treasury Management Practices (TMP's) and this part TMP 1 (5), covering investment counterparty policy requires approval each year.

Annual Investment Strategy

3. The key requirements of both the Code and the investment guidance are to set an annual investment strategy as part its annual Treasury Management strategy for the following year, covering the identification and approval of the following:

   (a) The strategy guidelines for decision making on investments, particularly non-specified investments.
   (b) The principles used to determine the maximum periods for which funds can be committed.
   (c) Specified investments the Council will use. These are high security (i.e. high credit rating, although this defined by the Council, and no guidelines are given), and high liquidity of investments in sterling with a maturity of no more than a year. This will need to define broad categories of investment and regularity of monitoring.
   (d) 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.

4. Specified and non-specified investments are both approved under the new guidance and both should normally form part of the Council's policy.

5. Throughout this Strategy the investments that will be used are Sterling fixed term or Variable deposits of up to 5 years with UK Banks and Building Societies, UK Government and other local authorities.

6. This Strategy is to be approved by Council.

Strategy Guidelines

7. The main principle governing the Council's investment criteria is the security and liquidity of its investments before yield, although yield or return on the investment will be a consideration, subject to adequate security and liquidity. After this main principle the Council will ensure:

   a) **It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may be prudently committed. These procedures also apply to the Councils prudential indicators covering maximum principal sums invested.**
   b) **It maintains a policy covering both 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.**

8. The Director of Corporate Services will maintain counterparty list in compliance with these criteria and will revise the criteria and submit it to Council for approval as necessary. The current proposed criteria are shown below

Liquidity of Investments

9. The Council will carefully balance the use of specified investments and non-specified investments into the future to ensure there is appropriate operational liquidity. In the normal course of the Council's cash flow operations it is expected that both specified and non-specified investments will be utilised for the control of liquidity as both categories allow for short term investments.

10. The use of longer term instruments (greater than one year from inception to repayment) will fall in the non-specified category. These instruments will only be used where the Council's liquidity requirements are safeguarded. An estimate of term investments is included in the main body of this report. The following estimates for longterm investments were included for the next three years 2009/10 £15m, 2010/11 £15m and 2011/12 £15m

Specified Investments

11. These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but 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 negligible. These would include investments with:-

    a) The UK Government (such as the Debt Management Office, UK Treasury Bills or gilts).

    b) Supranational bonds.

    c) A local authority, parish council or community council.

    d) An investment scheme that has been awarded a high credit rating by a credit rating agency. This covers money market funds rated AAA by Standard and Poors, Moody's or

Fitch rating agencies

e) A UK 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 :-

i) Short Term Rating- F1 (or equivalent) from Fitch, Moody's or Standard & Poors

ii) Long Term Rating- A- or equivalent from Fitch, Moody's or Standard & Poors

iii) Individual / Financial Strength Rating – C from Fitch or Moody's Support Rating – 3 from Fitch

12. Within these bodies and in accordance with the code, the Council has set additional criteria to set the time limit and amount of monies which will be invested.

Non-Specified Investments

13. Non-specified investments are any type of other investment not defined as Specified and will include any investments for more than one year. These would include :-

	Non Specified Category	Total Limit for category £m
a.	UK 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.	£24.000
b.	Any UK Bank or Building Society that has a minimum long term credit rating of A or equivalent for Fitch or Moody's, for deposits with a maturity of greater than one year. This would include forward deals in excess of one year from inception to repayment.	£15.000
c.	Guaranteed Organisations ie UK Nationalised Banks	£6.000
	Maximum Total Investments in Non Specified Category	£45.000

14. The table 1 below shows the minimum credit rating (or asset size, relating to Building Society's) required for inclusion on the Council counterparty list.

Table 1

	Fitch				Moody's			Asset Size
Type	**Short Term**	**Long Term**	**Ind.**	**Support**	**Short Term**	**Long Term**	**Financial Strength**	
UK Bank	F1	A-	C	3				-
MMF	AAA				AAA			-
DMADF	-				-			-
UK Building Society (1)					P-1	A3	C	-
UK Building Society (2)	-	-	-	-	-	-	-	>£1bn
Guaranteed Organisations								

15. Table 2 shows investment time and money limits categorised between specified and non specified investments

Table 2

	Fitch				Moody's			Asset Size		
Type	**Short Term**	**Long Term**	**Ind**	**Support**	**Short Term**	**Long Term**	**Financial Strength**		**Time Limit**	**Money limit**
Specified										
UKBank / Building Society	F1	A-	-	-	P-1				1 year	£5m
UK Building Society					P-2				9 months	£2m
MMF	AAA							-	1 year	£5m
DMADF	-				-			-	1 year	Unlimited
Non-Specified										
Un-rated UKBS	-	-	-	-	-	-	-	>£1bn	6 months	£2m
Guaranteed Organisations									3 months	£3m
Long term UK Bank / BS	F1	A-	C	3	P-1	A3	C		2 years	£3m
	F1	AA-	B	2	P-1	Aa3	B		4 years	£5m
	F1	AAA	B	1	P-1	Aaa	B		5 years	£5m

The Monitoring of Investment Counterparties

16. The credit rating of counterparties is monitored regularly. The Council receives credit rating advice from its advisers, Butlers, on a daily basis as and when ratings change, and counterparties are checked promptly. On occasions 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 Director of Corporate Services, and if required new counterparties which meet the criteria will be added to the list.