COUNCIL
3RD MARCH 2011

ITEM NO. 3 (b)

PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT STRATEGY REPORT 2011/12

Responsible Cabinet Member - Councillor Chris McEwan, Efficiency and Resources Portfolio

Responsible Director - Paul Wildsmith, Director of Resources

SUMMARY REPORT

Purpose of the Report

1. This report requests Council to adopt the following:-

    (a) The Prudential Indicators and Limits for 2011/12 to 2013/14 relating to capital expenditure and Treasury Management activity.

    (b) A policy statement relating to the Minimum Revenue Provision (MRP).

    (c) The Treasury Management Strategy 2011/12, which includes the Investment Strategy for 2011/12.

Summary

2. The profile of the Treasury Management function within Local Authorities was raised during the international banking crisis of 2008/09 and as a result CIPFA's Treasury Management Code of Practice was revised with practitioners reminded that the security of investments (the return of the principal invested and the interest due) and the liquidity (access to the cash at the appropriate time or when called back) are of more importance than the yield returned (the rate of interest paid).

3. Although Local Authorities may borrow for short term cashflow purposes the underlying longer term borrowing is always for capital purposes to cover the cost of our capital programme.

4. This report outlines the Council's prudential indicators for 2011/12 – 2013/14 and sets out the expected treasury operations for this period. It fulfils four key legislative requirements:

    (a) The reporting of the **prudential indicators** setting out the expected capital activities treasury management prudential indicators are now included as treasury indicators in the CIPFA Treasury Management Code of Practice;

(b) The Council's **Minimum Revenue Provision (MRP) Policy**, which sets out how the Council will pay for capital assets through revenue each year.

(c) The **treasury management strategy statement** which sets out how the Council's treasury service will support the capital decisions taken above, the day to day treasury management and the limitations on activity through treasury prudential indicators.

(d) The key indicator is the **Authorised Limit**, the maximum amount of debt the Council could afford in the short term, but which would not be sustainable in the longer term.

(e) The **investment strategy** which sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss.

5. 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.

6. This report was considered by Audit Committee at its special meeting on 28th January 2011 under their responsibilities for ensuring effective scrutiny of the treasury management and policies. Audit Committee resolved that it was satisfied with the Prudential Indicators and Treasury Management Strategy, as presented in this report and that the report be forwarded to Cabinet for its onward referral to Council for consideration.

7. Since consideration of this report by the Audit Committee the results of the Governments review of self-financing for council houses has become known. The indicators are that in order for the Council to buy itself out of the housing subsidy system the Council will be required to borrow an additional £27.300m for housing purposes. This additional borrowing has not been included in this report. A further report to update the prudential indicators will be taken to Audit Committee/ Cabinet/Council later in 2011 when the full implications of this are known. This additional borrowing will not impact on the General Fund and should not be required before March 2012.

Recommendation

8. The following are recommended for approval by Council:-

    (a) The Prudential Indicators and limits for 2011/12 to 2013/14 as summarised in Tables 1 and 2.
    (b) The Minimum Revenue Provision (MRP) statement contained within paragraph 32.
    (c) The Treasury Management Strategy 2011/12 – 2013/14 in paragraphs 44 to 63.
    (d) The Investment Strategy 2011/12 contained in paragraphs 64 to 84.

Reasons

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

(a) In order to comply with the Prudential code for Capital Finance in Local Authorities and the 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 Resources

Background Papers

Annual Statement of Accounts 2009/10
Draft MTFP 2011/12-2013/14

Elaine Hufford : Extension 2447

S17 Crime and Disorder	This report has no implications for S 17 Crime and Disorder
Health and Well Being	This report has no implications for the Councils Health and Well being agenda
Carbon Impact	This report has no implications for the Councils Carbon Emissions
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 report must be considered by Council
Urgent Decision	This report must be considered by Council
One Darlington: Perfectly Placed	This report has no particular implications for the sustainable Community Strategy
Efficiency	The report refers to actions taken to reduce costs and manage risks.

MAIN REPORT

Information and Analysis

10. This budgetary cycle provides for the seventh full year of 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 2010/11 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.

11. 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.

12. 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 2011/12 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.

13. 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.

14. Revised editions of the CIPFA Prudential Code and CIPFA Treasury Management Code of Practice were produced in November 2009 and the CLG Guidance on Local Government Investments in April 2010.

15. The main changes in the CIPFA Prudential Code and CIPFA Treasury Management Code of Practice were incorporated into the previous year's Strategy and again into this year's Strategy.

16. The revised guidance on investments has key revisions in the following areas:-

    (a) security and liquidity above yield
    (b) consideration of revised strategies
    (c) publishing of strategies
    (d) the use of credit ratings
    (e) treasury management advisors
    (f) the investment of monies borrowed in advance of spending needs

    All of these areas are covered in this report.

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

18. The Local Government Act 2003 requires the Council 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 Council's Draft Capital Medium Term Financial Plan.

19. Within this overall prudential framework there is an impact on the Council's treasury management activity, as it will directly impact on borrowing or investment activity. As a consequence the Treasury Management Strategy for 2011/12 to 2013/14 is included in Paragraphs 40 to 82 to complement these indicators. Some of the prudential indicators are shown in the treasury management strategy to aid understanding.

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

Table 1 – Capital Expenditure and Borrowing

	2010/11 Revised	**2011/12 Estimated**	**2012/13 Estimated**	**2013/14 Estimated**
	£m	£m	£m	£m
Capital Expenditure	42.962	31.261	13.560	13.151
Capital financing requirement	145.429	143.939	137.696	131.640
Operational boundary for external debt	117.548	116.693	115.371	114.080
Authorised limit for external debt	129.303	128.362	126.908	125.488
Ratio of financing costs to net revenue stream – General Fund	4.64%	4.68%	4.86%	4.88%
Ratio of financing costs to net revenue stream – HRA	8.53%	9.15%	11.04%	11.53%
Incremental impact of **new** capital investment decisions on the band D Council Tax	Nil	Nil	Nil	Nil
Incremental impact of **new** capital investment decisions on Housing Rents levels	Nil	Nil	Nil	Nil

Table 2 – Treasury Management

	2011/12 Upper Limit	2012/13 Upper Limit	2013/14 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	£10M	£10M	£10M

The Council's Capital Expenditure Plans

21. The Council's Capital Expenditure plans as outlined in the draft Medium Term Financial Plan (MTFP) for Capital will be partly financed by resources such as capital grants capital contributions and capital receipts etc. 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 and the impact on the CFR are shown in **Tables 3 and 4** below. The figures included in these tables represent the forecasted capital programme in Appendix 12 of the Draft Corporate Medium Term Financial Plan adjusted for any slippage from previous years 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**.

22. The Local Government Finance Settlement published in mid December 2010 indicated that support for the capital element of the settlement would be funded through capital grant rather than supported borrowing for the duration of the spending review period. Whilst there will be no new supported borrowing allocations, the level of assumed supported outstanding debt still forms part of the Formula Grant calculation and a contribution towards financing costs is still part of that grant.

23. The only new borrowing in the Capital Programme relates to unsupported borrowing for the Housing Account.

24. 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 limits on the Council’s capital expenditure plans. No such limits were implemented in the past five years and there is no indication of such controls in 2011/12.

25. A risk of the plan is the level of government support has some estimates included over the life of the plan some of this relates to timing of grants and some relates to the amount of grant 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 plans annually, taking account of changes in projected future years’ resources. Anticipated asset sales will generally be postponed until the property market improves.

26. 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 Draft Capital MTFP report. This forms the first prudential indicator.

Table 3

	2010/11 Revised	**2011/12 Estimate**	**2012/13 Estimate**	**2013/14 Estimate**
	£m	**£m**	**£m**	**£m**
Capital Expenditure				
Total Expenditure	**42.962**	**31.261**	**13.560**	**13.151**
Financed by				
Capital Receipts	0.621	0.300	0.350	0.350
Capital Grants	24.246	24.075	11.765	11.721
Capital Contributions	2.134	0.0	0.0	0.0
Revenue	2.573	2.340	1.445	1.080
Total Financing other than borrowing	29.574	26.715	13.560	13.151
Net financing need for the year	13.388	4.546	0.0	0.0

The Council’s borrowing Need (the Capital Financing Requirement)

27. The second prudential indicator is the Councils Capital Financing Requirement (CFR). The CFR is simply the total outstanding capital expenditure which has not yet been paid for by either revenue or capital resources. It is essentially a measure of the Council’s underlying borrowing need. The capital expenditure above which has not immediately been paid for will increase the CFR.

28. The Prudential Indicators produced in previous years have been based on the compilation of the authority's accounts under UK GAAP Accounting Standards. During 2009/10 and 2010/11 local authorities will start to compile their accounts under International Financial Reporting Standards (IFRS). Some assets that were off balance such as the PFI scheme for the Education Village and Harrowgate Hill School came on to the balance sheet during 2009/10. The reclassification of some of the Councils leases will mean that they also will come on to the balance sheet during 2010/11. This will increase the CFR on the balance sheet as this is expenditure for capital assets which is yet to be paid for. There will be no increase on revenue accounts resulting from this as charges relating to these assets are already included in the MTFP and have been for a number of years. Table 4 identifies the CFR relating to IFRS accounting entries separately.

29. The Council is asked to approve the CFR projections below

Table 4

	2010/11 Revised	**2011/12 Estimate**	**2012/13 Estimate**	**2013/14 Estimate**
	£m	**£m**	**£m**	**£m**
Capital Financing Requirement				
CFR – General Fund	83.617	79.465	75.233	71.158
CFR- General Fund PFI/ Leasing IFRS	25.048	23.693	22.371	21.080
Total CFR General Fund	108.665	103.158	97.604	92.238
CFR – Housing	36.764	40.781	40.092	39.402
Total CFR	**145.429**	**143.939**	**137.696**	**131.640**
Net movement in CFR	9.349	-1.490	-6.243	-6.056
Movement in the CFR represented by				
Net financing need for the year from Table 3	13.388	4.546	0.0	0.0
MRP General Fund	-3.666	-4.152	-4.232	-4.075
VRP General Fund	-1.000	0.0	0.0	0.0
MRP PFI	-1.540	-1.355	-1.322	-1.291
MRP Housing	-0.333	-0.529	-0.689	-0.690
CFR General Fund relating to PFI/Leasing IFRS	2.500			
Movement in CFR	9.349	-1.490	-6.243	-6.056

Minimum Revenue Provision Policy statement

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

31. 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.

32. 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 - 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) From 1st April 2008 for all unsupported borrowing- Asset life Method - MRP will be based on the estimated life of the assets in accordance with the proposed regulations. Repayments will be made on either an annuity basis or a straight line basis.

(c) Repayments relating to finance leases including the PFI scheme will be made in accordance with the principal repayments embedded in the lease scheme over the life of the lease

33. The expected impact of the capital expenditure decisions on the Councils debt and investment position is shown below :-

Table 5 Net Borrowing to CFR

	2010/11 Revised	**2011/12 Estimate**	**2012/13 Estimate**	**2013/14 Estimate**
	£m	**£m**	**£m**	**£m**
Borrowing	91.000	91.000	91.000	91.000
Less Investments	-15.000	-20.000	-20.000	-20.000
Net Borrowing	76.000	71.000	71.000	71.000
CFR (from Table 4)	145.429	143.939	137.696	131.640

TABLE 5a Local Indicator showing Net Borrowing plus commitments under IFRS for PFI etc.

	2010/11 Revised	**2011/12 Estimate**	**2012/13 Estimate**	**2013/14 Estimate**
	£m	**£m**	**£m**	**£m**
Borrowing	91.000	91.000	91.000	91.000
Add IFRS PFI/leased assets (from table 4)	25.048	23.693	22.371	21.080
Less investments	-15.000	-20.000	-20.000	-20.000
Total borrowing including IFRS PFI and leased assets	101.048	94.693	93.371	92.080
CFR (from Table 4)	145.429	143.939	137.696	131.640

34. Early in 2009/10 because of the current economic conditions a decision was taken to reduce actual debt by using investments to repay debt. This decision had 2 advantages

(a) it reduced the risk of investing with a counterparty (ie Bank or Building Society) that might not be able to honour its commitments and repay investments when they become due; and

(b) it reduced annual financing costs as the interest rate paid on debt is currently greater than the interest rate returned on investments.

35. The estimates above in **Table 5** assume that over the years 2011/12 to 2013/14 the economic climate will change little. It is expected that investment rates will remain below borrowing interest rates as at present, therefore investment levels will remain lower than in the past. Financing Costs within the draft MTFP reflect these expected levels of actual debt and investments.

Limit to Borrowing Activity

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

37. 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 2010/11 and next two financial years. This allows some flexibility for additional borrowing should the economic climate change.

38. The Council will comply with the prudential indicator requirement to keep borrowing below the relevant CFR in the current year and table 5 confirms that no difficulties are envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the draft Revenue and Capital MTFP's.

Affordability Prudential Indicators

39. 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 Council's overall finances. The Council is asked to approve the following indicators.

40. **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) against the net revenue stream.

Table 6 - Ratio of financing costs to net revenue stream

	2010/11 Revised	**2011/12 Estimate**	**2012/13 Estimate**	**2013/14 Estimate**
General Fund	**4.64%**	**4.68%**	**4.86%**	**4.88%**
HRA	**8.53%**	**9.15%**	**11.04%**	**11.53%**

41. The estimates of financing costs include current commitments and the proposals in the draft MTFP

42. **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 no new schemes over the life of the MTFP. So the impact of that proposal on Council Tax Band D will be nil. There may however be some departmental unsupported borrowing to be undertaken, the quantum of which is unknown at present, 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 Group resource allocations, which will therefore have no incremental effect on Council Tax.

Table 7 – Incremental impact of *new* capital investment decisions on the Band D Council Tax

	Proposed Budget 2011/12 £	**Forward Projection 2012/13 £**	**Forward Projection 2013/14 £**
Incremental impact of **new** capital investment decisions on the Band D Council Tax.	**Nil**	**Nil**	**Nil**

43. **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. In addition to this new borrowing is anticipated for the new build but additional rent income from these properties will cover these financing costs

Table 8 – Incremental impact of capital investment decisions Housing Rent levels

	Proposed Budget 2011/12 £	**Forward Projection 2012/13 £**	**Forward Projection 2013/14 £**
Weekly Housing Rents	**Nil**	**Nil**	**Nil**

Treasury Management Strategy 2011/12 – 2013/14

44. 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. Together they form part of the process which ensures the Council meets its balanced budget requirement under the Local Government Finance Act 1992

45. The Council's activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management –revised November 2009). This Council adopted the revised Code of Practice on Treasury Management on 16th February 2010 (Min. Ref. 145(c)/Feb/2010 refers).

46. As a result of adopting the Code the Council also adopted a revised Treasury Management Policy Statement (16/02/2010).

47. The Treasury Management Policy requires an annual strategy to be reported to Cabinet/Council outlining the expected treasury activity for the forthcoming 3 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 after the year-end to report on actual activity for the year, and a new requirement of the revised Code of Practice is that there is a mid-year monitoring report, however Cabinet/Council of this authority have been advised by such a report for a number of years.

48. This Strategy covers:

(a) The Councils debt and investment projections;
(b) The Councils estimates and limits on future debt levels;
(c) The expected movements in interest rates
(d) The Council's borrowing and investment strategies;
(e) Treasury Management Performance indicators;
(f) Specific Limits on Treasury Management activities;
(g) Any local Treasury Management issues.

Debt and Investment Projections 2011/12 – 2013/14

49. The borrowing requirement comprises of' the expected movement in CFR and any maturing debt which will need to be refinanced. The table 9 below shows this effect on the treasury position over the next three years. The expected maximum debt position during each year represents the Operational Boundary Prudential Indicator, and will be different from the year end position as it is adjusted to include estimated additional borrowing that may be required to cover Prudential borrowing for formerly leased assets and borrowing under Directors delegated powers.

Table 9- Operational Boundary

	2010/11	2011/12	2012/13	2013/14

	Revised	Estimated	Estimated	Estimated
Market/ PWLB debt (Table 5)	91.000	91.000	91.000	91.000
Other Long Term Liabilities under IFRS ie Leases and PFI (Table 4)	25.048	23.693	22.371	21.080
Total External Debt at 1st April	104.948	116.048	114.693	113.371
Expected Change in Debt	11.100	-1.355	-1.322	-1.291
Debt at 31st March	116.048	114.693	113.371	112.080
Add				
Estimated Additional Supported Borrowing	0.000	0.000	0.000	0.000
Prudential Borrowing for leasable assets	1.000	1.000	1.000	1.000
Prudential Borrowing under Directors delegated powers	0.500	1.000	1.000	1.000
Operational Boundary	**117.548**	**116.693**	**115.371**	**114.080**
Investments	15.000	15.000	20.000	20.000
Total Investments at 31 March	15.000	20.000	20.000	20.000
Investment Change	0.000	5.000	0.000	0.000
Net Borrowing	102.548	96.693	95.371	94.080

Limits to Borrowing Activity

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

51. For the first of these the Councils 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 2010/11 and the following two financial years (the relevant comparative figures are highlighted). This allows some flexibility for limited early borrowing for future years but ensures that borrowing is not undertaken for revenue purposes.

52. Table 5 is repeated below to illustrate this indicator

Net Borrowing to CFR from Table5

	2010/11 Revised	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate
	£m	£m	£m	£m
Net Borrowing	76.000	71.000	71.000	71.000
CFR (from Table 4)	145.249	143.939	137.696	131.640

53. The Director of Resources reports that the Council complied with this prudential indicator in the current year and does not envisage any difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the budget report.

54. **The Authorised Limit for External Debt -** A further key prudential indicator represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by

Council. It reflects the level of external debt which, while not desired, could be afforded in the short term but is not sustainable in the longer term.

55. This is the statutory limit determined under section 3 (1) of the local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although no control has yet been exercised.

56. The Council is asked to approve the following Authorised Limit:

Table 10 Authorised Limit

	2010/11 Revised	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate
Operational Boundary from table 9	**117.548**	**116.693**	**115.371**	**114.080**
Additional Headroom as a % of Operational Boundary	**10%**	**10%**	**10%**	**10%**
Authorised Limit	**129.303**	**128.362**	**126.908**	**125.488**

Expected movement in Interest Rates

57. There is always a risk to the Treasury Management Budget from adverse movement 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 Sector, 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. Sectors view of the UK and world economy and the effects this will have on the UK interest rates is attached at **Appendix 2** Forecast interest rates are summarised in Table 11.

Table 11- Medium Term Rate forecast- Annual Average % (Source source)

Year	Bank Rate	Investment Rates		PWLB rates			
		3 Month	1 Year	5 Years	10 Years	25 Years	50 Years
2010/11	0.5	0.7	1.5	2.6	3.7	4.6	4.7
2011/12	0.7	1.0	1.8	3.5	4.5	5.3	5.4
2012/13	1.7	2.0	2.8	4.2	4.8	5.5	5.6
2013/14	3.1	3.2	3.7	4.8	5.3	5.6	5.7

Borrowing and Debt Strategy 2011/12 -2013/14

58. The uncertainty over future interest rates increases the risks associated with treasury activity. As a result the Council will take a cautious approach to its treasury strategy.

59. Long- term fixed interest rates are at risk of being higher over the medium term, and short term rates are expected to rise, although modestly. The Director of Resources, 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 lower cost opportunities in the short/ medium term.

60. With the likelihood of long term rates increasing, debt restructuring is likely to focus on switching from longer term fixed rates to cheaper shorter term debt, although the Director of Resources and treasury consultants will monitor prevailing rates for any opportunities during the year.

61. Following the Comprehensive Spending review the PWLB increased borrowing interest rates by approximately 1%, without changing debt redemption rates. This will make debt rescheduling and premature repayment of debt more problematic in the future.

62. The option of postponing borrowing and running down investment balances may continue in the short to medium term. This will continue to reduce counterparty risk whilst hedging against expected low investment returns.

63. The results of the government's Housing Review to implement self-financing for council housing were released on 1st February 2011. The outcome of that for Darlington Borough Council is that there will be an additional borrowing requirement for the Housing Revenue Account in order for the Council to buy itself out of the housing subsidy system. The indications are that this will be £27.300m. This additional borrowing requirement has not been included in the estimates provided within this report for the HRA borrowing requirement. A further report will be taken to Audit Committee/Cabinet/Council later in 2011 when the full implications of this are known to update the prudential indicators. However, this additional borrowing will not impact on the General Fund and should not be required before March 2012.

Investment Strategy 2011/12-2013/14

64. **Key Objectives –** The Councils Investment Strategy primary objectives are safeguarding the repayments of the principal and interest of its investments on time then ensuring liquidity the investment return being the final objective. Following the economic background at present the current investment climate has one over-riding risk consideration, that of counterparty security. 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.

65. **Risk Benchmarking –** 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. Discrete security and liquidity benchmarks are new requirements to Member reporting, although the application of these is more subjective in nature. Additional background in the approach taken is attached at **Appendix 3.**

66. 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 that officers will monitor the current trend position and amend the operational strategy depending on any changes. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual report.

67. Security - The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:

    0.077% historic risk of default when compared to the whole portfolio. Appendix 3 holds more details on this calculation.

68. Liquidity – In respect of this area the Council seeks to maintain:

(a) Bank overdraft - £0.100m
(b) Liquid short term deposits of at least £3m available within a weeks notice.
(c) Weighted Average Life benchmark is expected to be 0.4 years, with a maximum of 1 year.

69. Yield - Local measures of yield benchmarks are :

(a) Investments – Short term – Cashflow investment rates returned against comparative rates.
(b) Investments- Longer term – Capital investments rates returned against comparative average rates.

70. And in addition that the security benchmark for each individual year is:

Table 12

	1 year	2 years	3 years
Maximum	**0.077%**	**0.056%**	**0.077%**

Note: This benchmark is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

71. **Investment Counterparty Selection Criteria -** 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:

(a) 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.

(b) 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.

72. The Director of Resources 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 provides an overall pool of counterparties considered high quality the Council may use rather than defining what its investments are.

73. 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 Council'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.

74. 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 (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (potential for change in the longer term) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance a negative rating watch applying to a counterparty at the minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions.

75. The criteria for providing a pool of high quality investment counterparties (both Specified and Non-specified investments) is:

(a) Banks 1 - Good Credit Quality **–** the Council will only use banks which:

(i) Are UK banks;

(b) And have, as a minimum, the following Fitch, Moody's and Standard and Poors ratings (where rated):

(i) Short Term **–** F1
(ii) Long Term **–** A-
(iii) Individual / Financial Strength – C (Fitch / Moody's only)
(iv) Support – 3 (Fitch only)

(c) Banks 2 – Guaranteed UK Banks with suitable Sovereign Support **–** In addition, the Council will use UK banks whose ratings fall below the criteria specified above if all of the following conditions are met:

(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 (This would include Northern Rock)

(d) Banks 3 – Eligible Institutions **-** the organisation is an Eligible Institution for the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008, with the necessary short and long term ratings required in Banks 1 above. These institutions have been subject to suitability checks before inclusion, and have access to HM Treasury liquidity if needed.

(e) Banks 4 **–** The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

(f) Building Societies**–** the Council will use all Societies which meet the ratings for banks outlined above. These may be eligible Institutions that have the necessary short and long term ratings

(g) Money Market Funds **–** AAA

(h) UK Government (including Gilts and the Debt Management Office)

(i) Local Authorities, Parish Councils etc

76. **Use of additional information other than credit ratings** – Additional requirements under the Code of Practice now require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, equity prices etc.) will be applied to compare the relative security of differing investment counterparties.

77. **Time and Monetary Limits applying to Investments -** The time and monetary limits for institutions on the Council's Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):

Table 13

	Fitch	**Moody's**	**Standard and Poors**	**Money Limit**	**Time limit up to**
Upper limit category	AA	Aa3	AA-	£5M	3 years
Lower limit category	A-	A3	A-	£3M	1 years
Money Market Funds	AAA	Aaa	AAA	£5M	Investments can be recalled at any time
Debt Management Office				Unlimited	6 months
Own bank				£3M	1 year
Local Authorities				£5M	1 year
Guaranteed Organisations				£3M	Terms of the guarantee
Eligible Institutions				£3M	1 year

78. The proposed criteria for Specified and Non-Specified investments are shown in **Appendix 4** or approval.

79. 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.

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

81. **Economic Investment Considerations -** Expectations on shorter-term interest rates, on which investment decisions are based, show likelihood of the current 0.5% Bank Rate remaining flat but with the possibility of a rise in mid-2011. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts.

82. There is an operational difficulty arising from the current economic climate. There is currently little value investing longer term as the higher rated institutions which fall into the higher credit criteria do not offer good returns for longer placed investments. Therefore in the near future investment will generally be placed for up to 1 year only. This will provide better security.

83. 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 Resources 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.

84. 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.

Sensitivity to Interest Rate Movement

85. 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 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 interest rate changes.

Table 14

	2011/12 Estimated + 1%	**2011/12 Estimated - 1%**
Revenue Budgets	**£'000**	**£'000**
Interest on Borrowing	92.730	-71.730
Related HRA Charge	-43.730	37.430

Net General Fund Borrowing Cost	49.000	-34.300
Investment income	-200.000	200.000
Net Effect on General Fund	-151.000	165.700

Treasury Management Limits on Activity

86. 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. The indicators are:

    (a) 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.

    (b) Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

    (c) Total principal funds invested for greater than 364 days – These limits are set with regard to the Council'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.

87. The Council is asked to approve the limits:

Table 15

	2011/12		**2012/13**		**2013/14**	
	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	**£5M**		**£10M**		**£10M**	

invested greater than 364 days			

Performance Indicators

88. 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. Performance Indicators to be used for the treasury function are:

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

    (b) Investments – Short Term- cashflow investment rate returned against comparative interest rates.

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

89. The results of these indicators will be reported in the Treasury Management Half Yearly Review and Annual Reports for 2010/11.

Treasury Management Advisers

90. The Council uses Sector as its treasury management consultants. The company provides a range of services which include:

    (a) Technical support on treasury matters, capital finance issues and the drafting of Member reports;

    (b) Economic and interest rate analysis;

    (c) Debt services which includes advice on the timing of borrowing;

    (d) Debt rescheduling advice surrounding the existing portfolio;

    (e) Generic investment advice on interest rates, timing and investment instruments;

    (f) Credit ratings from the three main rating agencies and other market information on counterparties.

91. 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 Council. This service is subject to regular review.

Member and Officer Training

92. The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a

suitable training process for Members and officers. This Council has addressed this important issue by:

(a) Two training sessions were developed in Late November /Early December 2009 for all members but with a special emphasis for the Audit Committee. These outlined the processes involved in compilation of the Treasury Management Strategy. The courses were well attended by the relevant members and well received.

(b) Officer training is provided by Sector, the Council's advisors, who organise regular seminars and also produce regular newsletters and papers on Treasury Management issues. In addition the Finance Manager for Treasury Management has recently studied and passed the Certificate in International Treasury Management – Public Finance, a new qualification from CIPFA and the Association of Corporate Treasurers brought in to address the training requirements of the revised Treasury Management Code of Practice.

APPENDIX 1

	CAPITAL EXPENDITURE AND THE SOURCES OF FINANCE					
			2010/11 Revised £m	**2011/12 Estimated £m**	**2012/13 Estimated £m**	**2013/14 Estimated £m**
	Capital Expenditure – General Fund					
1	Supported spend		22.419	19.929	7.634	7.597
2	Unsupported spend		6.454	0.0	0.0	0.0
3	Total spend	*Lines 1+2*	28.873	19.929	7.634	7.597
	Financed by:					
4	Capital receipts		0.0	0.0	0.0	0.0
5	Capital grants		18.196	19.929	7.634	7.597
6	Capital Contribution		2.134	0.0	0.0	0.0
7	Revenue		0.096	0.0	0.0	0.0
8	Total financing	*Lines4 to 7*	20.426	19.929	7.634	7.597
9	Net financing need	*3 – 8*	8.447	0.0	0.0	0.0
	Capital Expenditure - Housing Revenue Account					
10	Supported spend		6.050	4.146	4.131	4.124
11	Unsupported spend		8.039	7.186	1.795	1.430
12	Total spend	*10+11*	14.089	11.332	5.926	5.554
	Financed by:					
13	Capital receipts		0.621	0.300	0.350	0.350
14	Capital grants		6.050	4.146	4.131	4.124
15	Capital Contribution		0.0	0.0	0.0	0.0
16	Revenue		2.477	2.340	1.445	1.080
17	Total financing	*13 to 16*	9.148	6.786	5.926	5.554
18	Net financing need	*12 – 17*	4.941	4.546	0.0	0.0
	Capital Expenditure – Total					
19	Supported spend	*1+10*	28.469	24.075	11.765	11.721
20	Unsupported spend	*2+11*	14.493	7.186	1.795	1.430
21	Total spend	*19+20*	42.962	31.261	13.560	13.151
	Financed by:					
22	Capital receipts	*4+13*	0.621	0.300	0.350	0.350
23	Capital grants	*5+14*	24.246	24.075	11.765	11.721
24	Capital Contributions	*6+15*	2.134	0.0	0.0	0.0
25	Revenue	*7+16*	2.573	2.340	1.445	1.080
26	Total financing	*22 to 25*	29.754	26.715	13.560	13.151
27	**Net financing need**	*21 – 26*	**13.388**	**4.546**	**0.0**	**0.0**

APPENDIX 1

	THE CAPITAL FINANCING REQUIREMENT					
			2010/11 Revised £m	**2011/12 Estimated £m**	**2012/13 Estimated £m**	**2013/14 Estimated £m**
	The Capital Financing Requirement – General Fund					
28	CFR Opening Balance		79.836	83.617	79.465	75.233
29	Net financing need	*9*	8.447	0.0	0.0	0.0
30	Less MRP & VRP		-4.666	-4.152	-4.232	-4.075
31	CFR Closing balance	*28 to 30*	83.617	79.465	75.233	71.158
32	Net movement in CFR	*31-28*	3.781	-4.152	-4.232	-4.075
	The Capital Financing Requirement IFRS PFI Etc					
33	CFR Opening Balance		24.088	25.048	23.693	22.371
34	Leases now on Balance Sheet		2.500	0.0	0.0	0.0
35	Less MRP & VRP		-1.540	-1.355	-1.322	-1.291
36	CFR Closing balance		25.048	23.693	22.371	21.080
37	Net movement in CFR		0.960	-1.355	-1.322	-1.291
	The Capital Financing Requirement – HRA					
38	CFR Opening Balance		32.156	36.764	40.781	40.092
39	Net financing need	*18*	4.941	4.546	0.0	0.0
40	Less MRP & V RP		-0.333	-0.529	-0.689	-0.690
41	CFR Closing balance	*33 to 35*	36.764	40.781	40.092	39.402
42	Net movement in CFR	*36-33*	4.608	4.017	-0.689	-0.690
	The Capital Financing Requirement – Total					
43	CFR Opening Balance	*28+33+38*	136.080	145.429	143.939	137.696
44	Net financing need	*29+39*	13.388	4.546	0.0	0.0
45	Leases now on Balance Sheet	*34*	2.500		0.0	0.0
46	MRP & VRP	*30+35+40*	-6.539	-6.036	-6.243	-6.056
47	CFR Closing balance	*43+44+45-46*	145.429	143.939	137.696	131.640
	Net movement in CFR	*47-43*	**9.349**	**-1.490**	**-6.243**	**-6.056**

Appendix 2

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

1. There is significant uncertainty with economic forecasts. Whilst short-term rates are expected to remain on hold through most of 2011, inflationary concerns are increasing. Inflation has been above the 2% target for so long the credibility of the MPC may become a greater focus. This will make the MPC's decisions during 2011 a difficult judgment; control inflation or continue to aid the recovery? The MPC will be particularly concerned that the public's inflation expectations could become unhinged. There is a risk that the MPC may feel they will need to take action earlier than Q4, i.e. Q3, in order to reinforce its credibility.
2. The recovery in the economy is well underway; however, the strong rates of growth we have seen are unlikely to be sustained. The Government's determination to cut the size of the public sector deficit will be a drag upon activity in the medium term. The void left by significant cuts in public spending will need to be filled by a number of alternatives – corporate investment, rising exports (assisted by the fall in the value of sterling) and consumers' expenditure. In terms of sheer magnitude, the latter is the most important and strong growth in this area is by no means certain. The combination of the desire to reduce the level of personal debt, lack of access to credit and continued job uncertainty is likely to weigh heavily upon spending. This will be amplified by fiscal policy tightening, in the Comprehensive Spending Review. Without growth in personal spending remaining robust, any recovery in the economy is set to be weak and protracted.
3. Fiscal support in the US through the extension of tax cuts and monetary support through the extension of quantitive easing (QEII, with the potential for further easing), has had an adverse effect on world bond markets. Following the recent sell off the outlook for long-term interest rates is favourable in the near term, but is set to deteriorate again in the latter part of 2011. The increase in yields will be suppressed by continued investor demand for safe haven instruments following the uncertainties and unfolding tensions within the entire Eurozone. In addition to this, the market has been underpinned by evidence of moderating activity in major economies and the coalition government's determination to deal with the parlous state of public sector finances. These two factors will restrict any deterioration in longer term fixed interest rates in the near term.
4. However, while the UK's fiscal burden will almost certainly ease, it will be a lengthy process and deficits over the next two to three financial years will still require a very heavy programme of gilt issuance. The latest Bank Inflation Report suggests the market will not be able to rely upon Quantitative Easing indefinitely to alleviate this enormous burden.
5. Eventually, the absence of the Bank of England as a continued 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.
6. This incentive will take the form of higher yields. The longer end of the curve 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.
7. Although the FSA has recently delayed implementation of their liquidity requirements, the regulator will still look to ensure banks have necessary short term liquidity. The front end of

the curve will benefit from this and will ensure the steeply-positive incline of the yield curve remains intact.

Appendix 3

Security, Liquidity and Yield Benchmarking

Benchmarking and Monitoring Security, Liquidity and Yield in the Investment Service

1. A proposed development for Member reporting is the consideration and approval of security and liquidity benchmarks.

2. These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons in the Annual Treasury Report.

3. Yield – These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are

   (a) Investments – Short Term- cashflow investment rate returned against comparative interest rates
   (b) Investments – Longer term – capital investment rates returned against comparative average rates

4. Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. However they have not previously been separately and explicitly set out for Member consideration. Proposed benchmarks for the cash type investments are below and these will form the basis of future reporting in this area. In the other investment categories appropriate benchmarks will be used where available.

5. Liquidity – This is defined as "having adequate, though not excessive cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives" (CIPFA Treasury Management Code of Practice). In respect of this area the Council seeks to maintain:

   (a) Bank overdraft - £0.100M
   (b) Liquid short term deposits of at least £3M available with a week's notice.

6. The availability of liquidity and the term risk in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – shorter WAL would generally embody less risk. In this respect the proposed benchmark is to be used:

WAL benchmark is expected to be 0.4 years, with a maximum of 1 year.

7. Security of the investments – In context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard and Poors). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy. The table beneath shows average defaults for differing periods of investment grade products for each Fitch long term rating category over the period 1990 to 2009.

8.

Long term rating	1 year	2 years	3 years	4 years	5 years
AAA	**0.000%**	**0.014%**	**0.051%**	**0.099%**	**0.165%**
AA	**0.027%**	**0.056%**	**0.077%**	**0.1405**	**0.205%**
A	**0.077%**	**0.215%**	**0.367%**	**0.517%**	**0.699%**
BBB	**0.235%**	**0.685%**	**1.191%**	**1.788%**	**2.422%**

9. The Council's minimum long term rating criteria is currently "A-" , meaning the average expectation of default for a one year investment in a counterparty with a "A-" long term rating would be 0.077% of the total investment (e.g. for a £1m investment the average loss would be £770). This is only an average - any specific counterparty loss is likely to be higher - but these figures do act as a proxy benchmark for risk across the portfolio.

10. The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables, is:

0.077% historic risk of default when compared to the whole portfolio.

And in addition that the security benchmark for each individual year is:

	1 year	2 years	3 years
Maximum	**0.077%**	**0.056%**	**0.077%**

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members in the Investment Annual Report. As this data is collated, trends and analysis will be collected and reported. Where a counterparty is not credit rated a proxy rating will be applied.

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

1. The CLG issued Investment Guidance in 2010, 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 under 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 the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council originally adopted the Code on 21st March 2002 and will apply its principles to all investment activity. In accordance with the Code, the Director of Resources has produced its treasury management practices (TMPs). 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 of its annual treasury strategy for the following year, covering the identification and approval of following:

   (a) The strategy guidelines for choosing and placing investments, particularly non-specified investments.
   (b) The principles to be 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 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.
   (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. The investment policy proposed for the Council is:

Strategy Guidelines

5. The main strategy guidelines are contained in the body of the treasury strategy statement.

Specified Investments

6. 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 considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments which would not be defined as capital expenditure with:

(a) The UK Government (such as the Debt Management Account deposit facility, UK Treasury Bills or Gilts with less than one year to maturity).
(b) Supranational bonds of less than one year's duration.
(c) A local authority, parish council or community council.
(d) Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. For category d this covers pooled investment vehicles, such as money market funds, rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.
(e) A body that is considered of a high credit quality (such as a bank or building society). For category e this covers bodies with a minimum short term rating of F1 (or the equivalent) as rated by Standard and Poor's, Moody's or Fitch rating agencies.

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

Non-Specified Investments

8. Non-specified investments are any other type of investment (i.e. not defined as Specified above).

	Non Specified Investment Category	**Limit (£ or %)**
a.	**Eligible Institutions -** the organisation is an Eligible Institution for the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008, with the necessary short and long term ratings required in Banks 1 above (see Paragraph 70 in main report) These institutions have been subject to suitability checks before inclusion, and have access to HM Treasury liquidity if needed.	50%
b.	The Council's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.	£3M
c.	Any **bank or building society** that has a minimum long term credit rating of AA-, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	£10M

9. The table below shows the minimum credit rating for inclusion on the Council counterparty list

Table 1

	Fitch				Moody's		
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
Eligible Institutions	F1	A-	-		P-1-	A3-	-
Guaranteed Organisations							

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

Table 2

	Fitch				Moody's				
Type	**Short Term**	**Long Term**	**Ind**	**Support**	**Short Term**	**Long Term**	**Financial Strength**	**Time Limit**	**Money limit**
UKBank / Building Society	F1	A-	-	-	P-1			1 year	£3m
MMF	AAA							Call	£5m
DMADF	-				-			6 months	Unlimited
Guaranteed Organisations								Term of Guarantee	£3m
Eligible Institutions								1 year	£3m
Long term UK Bank / BS	F1	AA-	C	3	P-1	A3	C	3 years	£5m

The Monitoring of Investment Counterparties

11. The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Sector 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 Director of Resources, and if required new counterparties which meet the criteria will be

added to the list.