COUNCIL

24 FEBRUARY 2011

TREASURY MANAGEMENT STRATEGY 2011/2012

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Summary

This report seeks Council's approval of the Council's Treasury Management Strategy for the 2011/2012 financial year. The Treasury Management Strategy incorporates within it the Treasury Management Policy Statement, Annual Investment Strategy and Minimum Revenue Provision policy.

1. Budget and Policy Framework

1.1 The Council is asked to consider the views of the Business Support Overview and Scrutiny Committee and Cabinet and approve the Council's Treasury Management Strategy. The Business Support Overview and Scrutiny Committee is responsible for the scrutiny of the Council's Treasury Management, Investment Strategy and Minimum Revenue Provision Policy Statement.

1.2 Approving Policy and the setting of prudential indicators is a matter for Council.

2. Background

2.1 Treasury management is defined as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2.2 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council on 25 February 2010.

2.3 The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.
4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices, this has been delegated to Cabinet and for the execution and administration of treasury management decisions has been delegated to the Chief Finance Officer.
5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body, this has been delegated to Business Support Overview and Scrutiny.

2.4 The suggested strategy for 2011/2012 in respect of the following aspects of the treasury management function is based upon the treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury adviser, Sector.

The strategy covers:

- treasury limits in force which will limit the treasury risk and activities of the Council
- Prudential and Treasury Indicators
- the current treasury position
- the borrowing requirement
- prospects for interest rates
- the borrowing strategy
- policy on borrowing in advance of need
- debt rescheduling
- the investment strategy
- creditworthiness policy
- policy on use of external service providers
- the MRP strategy

2.5 In exercising the delegations to fulfil the responsibilities set out in the Treasury Management Strategy the Council will establish a set of standards to govern the manner in which these responsibilities are exercised. These standards are referred to as the Treasury Management Practices and are and are the detail by which the Chief Finance Officer will ensure the proper stewardship of the Treasury function is maintained. These were noted by Cabinet.

3. Balanced Budget Requirement

3.1 It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore, means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from: -

1. increases in interest charges caused by increased borrowing to finance additional capital expenditure, and
2. any increases in running costs from new capital projects are limited to a level which is affordable within the projected income of the Council for the foreseeable future

4. Treasury Limits for 2011/12 to 2013/14

4.1 It is a statutory duty under Section 3 of the Act and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the "Affordable Borrowing Limit". In England and Wales the Authorised Limit represents the legislative limit specified in the Act.

4.2 The Council must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax and council rent levels is 'acceptable'.

4.3 Whilst termed an "Affordable Borrowing Limit", the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years; details of the Authorised Limit can be found in Appendix 3 of this report.

4.4 For 2012/2013 the current Housing Subsidy regime will cease in favour of a new 'self-financing' model which will involve the transfer of the current liability under the subsidy calculation into a debt burden. The CLG have clarified since this report was considered by Overview and Scrutiny that this debt burden will be £15.6 million of borrowing against the Housing Revenue Account. At the time of the Overview and Scrutiny it was believed this figure would be in the region of £11m. Clarification has also now been obtained that this transaction will feature in the capital financing requirement calculation as debt incurred in April 2012. The authorised limit includes this additional debt as part of the limit for 2012/2013. Officers believe that the adjustment in 2012/2013 is appropriate and that the value is within the tolerance for the authorised limit. Figures relating to Capital Financing Requirement and borrowing requirements in appendix 3 and table 3 have been amended appropriately.

5. Current Portfolio Position

5.1 The Council's treasury portfolio position as at 31 March 2011 is anticipated to be:

Table 1		Principal		Ave. rate
		£m	£m	%
Fixed rate funding	PWLB	71.43		
	Market	101.80	173.23	4.13
Variable rate funding	PWLB	0.00		
	Market	0.13	0.13	0.50
Other long term liabilities			0.00	
Gross debt			**173.36**	
Inhouse Investments		57.90		1.00
Investec Investments		22.45		1.00
Total investments			**80.35**	
Net debt			**93.01**	

6. Borrowing Requirement

6.1 The Council's borrowing requirement is as shown in table 2 and indicates a lack of external borrowing for the foreseeable future because of the relative position of investment returns and rates for new borrowing.

Table 2	2010/2011	2011/2012
	£'000 probable	**£'000 estimate**
New supported borrowing	12,088	5,333
New prudential borrowing	3,743	2,500
Replacement borrowing	0	0
Total borrowing requirement	15,831	7,833

Note: all new borrowing is currently using internal funds rather than PWLB or the market

7 Prudential and Treasury Indicators for 2011/2012 – 2013/2014

7.1 Prudential and Treasury Indicators (as set out in tables 5, 6 and 7 in appendix 3 to this report) are relevant for the purposes of setting an integrated treasury management strategy.

7.2 The Council is required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. The original 2001 Code was adopted on 17 February 2002 and the revised 2009 Code was adopted by the full council on 25 February 2010.

8. Prospects for Interest Rates

8.1 The Council has appointed Sector as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates. Appendix 2 draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. The following table gives the Sector central view.

Sector Bank Rate forecast for financial year ends (March)

- 2010/ 2011 0.50%
- 2011/ 2012 1.00%
- 2012/ 2013 2.25%
- 2013/ 2014 3.25%

8.2 There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected. A detailed view of the current economic background is contained within Appendix 4 to this report.

9. Borrowing Strategy

9.1 Borrowing rates

9.1.1 The Sector forecast for the PWLB new borrowing rate is as follows: -

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13
Bank Rate	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.25%	2.75%
5Yr PWLB	3.30%	3.30%	3.40%	3.50%	3.60%	3.80%	3.90%	4.10%	4.30%	4.60%
10Yr PWLB	4.40%	4.40%	4.40%	4.50%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
25yr PWLB	5.20%	5.20%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%
50yr PWLB	5.20%	5.20%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%

9.1.2 A more detailed Sector forecast is included in Appendix 2.

9.2 As referred to in paragraph 6.1, due to the very low interest rates being earned on investments and restrictions to mitigate counterparty risk, officers will be repaying existing and deferring taking out new debt. However, in the event that it was deemed advantageous to borrow then we will evaluate the economic and market factors to form a view on future interest rates so as to determine the manner and timing of decisions to borrow.

9.3 Sensitivity of the forecast – In normal circumstances the main sensitivities of the forecast are likely to be the two scenarios noted below. The Council officers, in conjunction with the treasury advisers, will continually monitor both the prevailing interest rates and the market forecasts, adopting the following responses to a change of sentiment:

- *if it were felt that there was a significant risk of a sharp FALL in long and short term rates,* e.g. due to a marked increase of risks around relapse into recession or of risks of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

- *if it were felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,* perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

10. External v. internal borrowing

TABLE 3: Comparison of gross and net debt positions at year end	**2009/2010**	**2010/2011**	**2011/2012**	**2012/2013**	**2013/2014**
	actual	**probable out-turn**	**estimate**	**estimate**	**estimate**
	£'000	£'000	£'000	£'000	£'000
Actual external debt (gross)	198,408	173,361	163,325	153,312	143,312
Cash balances	88,779	80,349	74,293	20,507	15,171
Net debt	109,629	93,012	89,032	132,804	128,141

10.1 It is anticipated that the difference between gross debt and net debt (after deducting cash balances), by the end of the current financial year will be £80m.

10.2 The general aim of this treasury management strategy is to reduce the difference between the two debt levels over the next three years in order to reduce the credit risk incurred by holding investments. However, measures taken in the last year have already reduced substantially the level of credit risk (see paragraph 9.2) so another factor which will be carefully considered is the difference between borrowing rates and investment rates to ensure the Council obtains value for money once an appropriate level of risk management has been attained to ensure the security of its investments.

10.3 The next financial year is expected to be one of historically abnormally low Bank Rate. This provides a continuation of the current window of opportunity for local authorities to fundamentally review their strategy of undertaking new external borrowing.

10.4 Over the next three years, investment rates are therefore expected to be below long term borrowing rates and so value for money considerations would indicate that value could best be obtained by avoiding new external borrowing and by using internal cash balances to finance new capital expenditure or to replace maturing external debt (this is referred to as internal borrowing). This would maximise short term savings.

10.5 However, short term savings by avoiding new long term external borrowing in 2011/2012 will also be weighed against the potential for incurring additional long term extra costs by delaying unavoidable new external borrowing until later years when PWLB long term rates are forecast to be significantly higher.

10.6 The Council has examined the potential for undertaking early repayment of some external debt to the PWLB in order to reduce the difference between its gross and net debt positions. However, the introduction by the PWLB of significantly lower repayment rates than new borrowing rates in November 2007, which has now been compounded since 20 October 2010 by a considerable further widening of the difference between new borrowing and repayment rates, has meant that large premiums would be incurred by such action and would also do so in the near term; such levels of premiums cannot be justified on value for money grounds. This situation will be monitored in case these differentials are narrowed by the PWLB at some future date.

10.7 Against this background caution will be adopted with the 2011/2012 treasury operations. The Chief Finance Officer will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to the appropriate decision making body at the next available opportunity.

11. Policy on borrowing in advance of need

11.1 The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Council can ensure the security of such funds.

11.2 In determining whether borrowing will be undertaken in advance of need the Council will: -

- ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to take funding in advance of need
- ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow
- consider the merits and demerits of alternative forms of funding
- consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use

- consider the impact of borrowing in advance on temporarily (until required to finance capital expenditure) increasing investment cash balances and the consequent increase in exposure to counterparty risk, and other risks, and the level of such risks given the controls in place to minimise them.

12. Debt Rescheduling

12.1 The introduction by the PWLB in 2007 of a spread between the rates applied to new borrowing and repayment of debt, which has now been compounded since 20 October 2010 by a considerable further widening of the difference between new borrowing and repayment rates, has meant that PWLB to PWLB debt restructuring is now much less attractive than it was before both of these events. In particular, consideration would have to be given to the large premiums which would be incurred by prematurely repaying existing PWLB loans and it is very unlikely that these could be justified on value for money grounds if using replacement PWLB refinancing. However, some interest savings might still be achievable through using LOBO (Lenders Option Borrowers Option) loans, and other market loans, in rescheduling exercises rather than using PWLB borrowing as the source of replacement financing.

12.2 As short term borrowing rates will be considerably cheaper than longer-term rates, there may be potential for some residual opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the size of premiums incurred, their short term nature, and the likely cost of refinancing those short term loans, once they mature, compared to the current rates of longer term debt in the existing debt portfolio.

12.3 The reasons for any rescheduling to take place will include: -

- the generation of cash savings and / or discounted cash flow savings
- helping to fulfil the strategy outlined in paragraph 9 above
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

12.4 Consideration will also be given to identify if there is any residual potential left for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

13. Annual Investment Strategy

13.1 Investment Policy

13.1.1 The Council will have regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2009 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities are: -

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

13.1.2 The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Council is low in order to give priority to security of its investments.

13.1.3 The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

13.1.4 Investment instruments identified for use in the financial year are listed in Appendix 5 under the 'Specified' and 'Non-Specified' Investments categories.

13.2 Creditworthiness policy

13.2.1 This Council uses the creditworthiness service provided by Sector. This service has been progressively enhanced over the last year and now uses a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moodys and Standard and Poors, forming the core element. However, it does not rely solely on the current credit ratings of counterparties but also uses the following as overlays: -

- Credit watches and credit outlooks from credit rating agencies
- CDS spreads to give early warning of likely changes in credit ratings
- Sovereign ratings to select counterparties from only the most creditworthy countries

13.2.2 This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour code bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Council to determine the duration for investments and are therefore referred to as durational bands. The Council is satisfied that this service now gives a much improved level of security for its investments. It is also a service which the Council would not be able to replicate using in house resources.

13.2.3 The selection of counterparties with a high level of creditworthiness will be achieved by selection of institutions down to a minimum durational band within Sector's weekly credit list of worldwide potential counterparties. The Council will therefore use counterparties within the following durational bands which are colour coded for ease of recognition:

- Yellow 5 years *
- Purple 2 years
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 3 months
- No Colour not to be used

** Sector note: this category has been added for AAA rated Government debt or its equivalent; please also see collateralised deposits added into Appendix 5 as a new investment instrument.*

13.2.4 This Council does not use the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine creditworthy counterparties as Moodys tend to be more aggressive in giving lower ratings than the other two agencies. In practice this means an over reliance on the one agency view and if applied could leave the Council with few banks on its approved lending list. The Sector creditworthiness service does still use ratings from all three agencies, but by using a risk weighted scoring system, does not give undue preponderance to any one agency's ratings.

13.2.5 All credit ratings will be monitored continuously by Officers. The Council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service.

- if a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of Credit Ratings the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Councils lending list.

13.2.6 Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on government support for banks and the credit ratings of that government support.

13.2.7 Investec use the following methodology to compile its counterparty list:

(a) Ratings set by Fitch IBCA

(b) Credit Default Swap levels (CDS's)

(c) Subjective Overlay

13.2.8 The Fund Managers "score" the markets current attitude to our counterparties on the standard lending list.

13.2.9 Scores are given for the following three important tests:

1. Will a bank buy back its own certificates of deposits (CDs) from us? If the answer is "Yes" this is seen as a signal that there is satisfactory liquidity and a low score will result. A "No" will lead to a high score to reflect the more restricted liquidity and the need to use the secondary market in order to dispose of a holding.

2. Is the bank a frequent or rare issuer of CDs? Frequent issuers are likely to be less attractive in the secondary market (e.g. investment houses "may be full of the name" or the issuing bank may be viewed as having an above average need for new funding). Rare issuers will be more highly regarded.

3. Do CDs issued by the banks trade “well” in the secondary market? The market’s appetite for CDs is seen as a signal about credit concerns or otherwise for any bank.

13.3 Counterparty Limits

13.3.1 Limits need to be set for amounts invested with any individual counterparty at any given moment. The relevant limits are currently set at £20m per counterparty for the in-house team and 20% of the managed portfolio for the fund manager. With these limits and the current in-house portfolio of an average of some £80 million there have been occasions when the in-house team have been stretched to invest at reasonable returns.

13.3.2 The Academy programme currently underway will add to these difficulties in that it is anticipated that in March 2011 the Council will be in receipt of an initial funding grant of £26.6m with a further two instalments in the summer of 2011 totalling approximately £50m for the funding of the building of these three new academies. This will result in the need to invest approximately an additional £70m above our current levels in the summer of 2011 although this will diminish as the cash outflows occur.

13.3.3 Officers are investigating various proposals on how this money should be invested, within the policy dictated above. However, to assist in this it is suggested that the in-house counterparty limit is raised to £25m for counterparties with a Sector duration rating of 12 months or above. This would have the effect of increasing officers’ ability to invest a further £35m in the highest rated counterparties.

13.3.4 In addition to this, officers are investigating adding further high quality counterparties to our in-house list, extending the use of Money Market Funds and increasing the sum invested via our fund manager. All initiatives will be within the approved Treasury Strategy and will be carefully considered by the Chief Finance Officer.

13.3.5 No amendments are requested to the Fund Manager counterparty limits.

13.3.6 The in-house team and Fund Manager both have the ability to invest unlimited sums with the Debt Management Agency Deposit Facility as this is effectively an office of Central Government. The down side to this investment is that the rate of return is very low (currently circa 0.2%).

13.4 Country limits

13.4.1 The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch Ratings (or equivalent from other agencies if Fitch does not provide a rating). The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 6. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

13.4.2 The Country limit will be reinforced by the application of a financial limit to investment such that a maximum of £40 million may be invested in any one country save for the United Kingdom where no limit is imposed.

13.5 <u>Investment Strategy</u>

13.5.1 In-house funds*:* The Council's in-house managed funds are derived from core balances and cash flow activity. The major part of these funds would normally be available for medium-term investments (less than 3 years). However the policy of running down balances to reduce credit risk and revenue costs from borrowing, as against minimal investment returns, means that such medium-term investments are very unlikely. Officers will monitor this position and if advantageous, then investments will accordingly be made with reference to the core balance, cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

13.5.2 Shown below are investments already made that extend into 2011/2012

	Amount £m	*Maturity*	*Rate*
NatWest Bank (Flippable Range Accrual)	*10*	*26/09/2011*	*0.35% over 3mth LIBOR reset every 3 months. Current rate 1.10563%*
Lloyds TSB	*20*	*23/11/2011*	*1.95%*

13.5.3 Interest rate outlook: Bank Rate has been unchanged at 0.50% since March 2009. and commentators forecast rates to remain at this level until quarter 3 of 2010 and then to rise steadily from thereon. This will obviously be affected by economic factors as they fall but Bank Rate forecasts for financial year ends (March) are as follows: -

- 2010/ 2011 0.50%
- 2011/ 2012 1.00%
- 2012/ 2013 2.25%
- 2013/ 2014 3.25%

13.5.4 There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected.

13.5.5 The Council will avoid locking into longer term deals while investment rates are down at historically low levels unless attractive rates are available with counterparties of particularly high creditworthiness which make longer term deals worthwhile and within the risk parameters set by this council.

13.6 <u>End of year investment report</u>

13.6.1 At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

13.7 <u>External Fund Manager</u>

13.7.1 £22.3m of the Council's funds are externally managed on a discretionary basis by Investec Asset Management.

The Council's external fund manager(s) will comply with the Annual Investment Strategy. The agreement between the Council and the fund manager additionally stipulate guidelines and duration and other limits in order to contain and control risk.

For Investec the minimum credit criteria to be used by the cash fund manager(s) are as follows: -

	Fitch
Long Term	AA-
Short Term	F1+
Individual/Financial Strength	C
Support	1

13.8 Policy on the use of external service providers

13.8.1 The Council uses Sector as its external treasury management advisers.

13.8.2 The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

13.8.3 It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

14 Kent County Council (KCC) Local Government Reorganisation (LGR) Debt

14.1 The charge for the share of KCC debt for which Medway Council was responsible on local government reorganisation is based on the current average cost of debt for the County Council as a whole. KCC rates had been decreasing year-on-year as the County took on cheaper new debt but this has recently marginally reversed as the repayment of debt for the cheaper short-term loans distills costs to the higher rates. Whilst the County rate at a projected 5.21% remains marginally higher than our own average debt rate of 4.27% for 2010/2011, the margin between PWLB debt rates for new borrowing and restructured debt (currently 5.46% vs 4.35% for 25 year borrowing) is such that this saving would be negated by the penalty involved. The outstanding principal at 1 April 2011 will be £47.1m.

Table 4 - Current and Historical Rates of Interest Charged on KCC LGR debt

Year	2006/07 Actual	2007/08 Actual	2008/09 Actual	2009/10 Actual	2010/11 Estimate	2011/12 Estimate
Rate	5.77%	5.74%	5.51%	5.08%	5.21%	5.34%

15. Minimum Revenue Provision

15.1 The Minimum Revenue Provision is explained and the Policy Statement for 2011/2012 is set out at Appendix 1. The MRP calculation is currently being reviewed by officers, in order to apply the most financially advantageous and yet prudent approach to MRP. The Policy shown as Appendix 1 is based upon the existing MRP Policy Statement but amended to include variations recommended by our consultant advisors, Sector.

16 Business Support Overview and Scrutiny Committee

16.1 The Business Support Overview and Scrutiny Committee considered this report on 27 January 2011 and agreed to recommend this report to Cabinet and Council.

16.2 Since this report was considered by overview and scrutiny committee the Housing Subsidy regime has been clarified and the transfer of liability under the subsidy calculation into a debt burden will be for £15.6m rather than the assumed £11m in 2012/2013. This has meant that the following paragraphs, tables and figures within appendix 3 have been amended to reflect this:

- Paragraph 4.4
- Table 3 – Cash Balances and Net Debt for years 2012/2013 and 2013/2014
- Appendix 3, Net Borrowing Requirement 2012/2013 and 2013/2014
- Appendix 3, HRA and Total Capital Financing Requirement for 2012/2013 and 2013/2014
- Appendix 3, Annual change in Capital Financing Requirement 2012/2013 and 2013/2014.
- Appendix 3, Authorised Limits and Operational Boundary for 2012/2013 and 2013/2014

16.3 During the recalculation of the above an error was discovered in appendix 3 covering “Ratio of financing costs to net revenue stream” and “Incremental impact of capital investment decisions – Increase in council tax (band D) per annum” figures for 2012/2013 and 2013/2014. As appendix 3 was being amended we took this opportunity to correct that error in this report.

16.4 Officers have sent a briefing to all members of the Business Support Overview highlighting the changes made to the report.

17 Cabinet

17.1 The Cabinet considered this report on 15 February and its recommendation is set out in paragraph 20 below (decision no. 22/2011 refers).

18 Risk management

18.1 As stated within the Treasury Strategy, a key driver for the review of the CIPFA code has been the exposure to risk evidenced by the Icelandic investments and more generally by the financial crisis. Risk and the management thereof is a feature throughout this report.

19. Financial and legal implications

19.1 The finance and legal positions are set out throughout the main body of the report.

20. Recommendation

20.1 The Cabinet recommends to Council the Treasury Management Strategy and associated policies and strategy statements as attached to the report.

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Background papers

Various records and documents held within Finance
Investec reports
Sector reports.

Appendices

1. MRP strategy
2. Interest rate forecasts
3. Prudential and Treasury indicators
4. Economic background
5. Specified and non specified investments
6. Approved countries for investments

APPENDIX 1

Minimum Revenue Provision

1. What is a Minimum Revenue Provision?

The Council uses borrowing to fund some items of Capital expenditure which is generally expenditure on assets which have a life expectancy of more than one year e.g. buildings, vehicles, machinery etc. The Council is obliged to repay the principal sum borrowed together with any interest attached to the borrowing. The repayment of principal has to be set aside from revenue and it would be impractical to charge the entirety of such expenditure to revenue in the year in which it was incurred. The amount to be provided is therefore spread over time such that the total sum is available to cover the liability for repayment as it occurs. The manner of spreading these costs is through an annual Minimum Revenue Provision, which was previously determined under Regulation, and is now determined under Guidance.

2. Statutory duty

Statutory Instrument 2008 no. 414 s4 lays down that:

“A local authority shall determine for the current financial year an amount of minimum revenue provision that it considers to be prudent.”

The above is a substitution for the previous requirement to comply with regulation 28 in S.I. 2003 no. 3146 (as amended).

There is no requirement to charge MRP where the Capital Financing Requirement is nil or negative at the end of the preceding financial year (in practice this would mean that there is no outstanding borrowing to repay).

The share of Housing Revenue Account CFR is not subject to an MRP charge and excluded from the calculation.

3. Government Guidance

Along with the above duty, the Government issued guidance which came into force on 31 March 2008 which requires that a Statement on the Council’s policy for its annual MRP should be submitted to the full Council for approval before the start of the financial year to which the provision will relate.

The Council is legally obliged to “have regard” to the guidance, which is intended to enable a more flexible approach to assessing the amount of annual provision than was required under the previous statutory requirements. The guidance offers four main options under which MRP could be made, with an overriding recommendation that the Council should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits. The requirement to ‘have regard’ to the guidance therefore means that:

1. Although four main options are recommended in the guidance, there is no intention to be prescriptive by making these the only methods of charge under which a local authority may consider its MRP to be prudent.

2. It is the responsibility of each authority to decide upon the most appropriate method of making a prudent provision, after having had regard to the guidance.

Minimum Revenue Provision Policy Statement 2011/12

The Council implemented the new Minimum Revenue Provision (MRP) guidance in 2007/2008, and assessed MRP for 2007/2008 onwards in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

In setting the Minimum Revenue Provision Policy, Medway Council has regard to the guidance and will set a policy to ensure a prudent provision for the repayment of debt.

The major proportion of the MRP for 2011/12 will relate to the more historic debt liability that will continue to be charged at the rate of 4%, in accordance with option 1 of the guidance.

Certain expenditure reflected within the debt liability at 31 March 2011 will, under delegated powers be subject to MRP under option 3, which will be charged over a period which is reasonably commensurate with the estimated useful life applicable to the nature of expenditure, using the equal annual instalment method (or annuity method if appropriate). For example, capital expenditure on a new building, or on the refurbishment or enhancement of a building, will be related to the estimated life of that building.

The Council will treat all expenditures as not ranking for MRP until the year after the scheme or asset to which they relate is completed and/or brought into use, rather than confine this approach solely to expenditures treated for MRP purposes under Option 3

Estimated life periods will be determined under delegated powers. To the extent that expenditure is not on the creation of an asset and is of a type that is subject to estimated life periods that are referred to in the guidance, these periods will generally be adopted by the Council. However, the Council reserves the right to determine useful life periods and prudent MRP in exceptional circumstances where the recommendations of the guidance would not be appropriate.

As some types of capital expenditure incurred by the Council are not capable of being related to an individual asset, asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure. Also, whatever type of expenditure is involved, it will be grouped together in a manner which reflects the nature of the main component of expenditure and will only be divided up in cases where there are two or more major components with substantially different useful economic lives.

In the case of long term debtors arising from loans or other types of capital expenditure made by the Council which will be repaid under separate arrangements (such as long term investments), or where borrowing has occurred but will be repaid by future Capital Receipts or agreed income from other source, there will be no Minimum Revenue Provision made.

APPENDIX 2

Interest Rate Forecasts

The data below shows a variety of forecasts published by a number of institutions. The first three are individual forecasts including those of UBS and Capital Economics (an independent forecasting consultancy). The final one represents summarised figures drawn from the population of all major City banks and academic institutions.

The forecast within this strategy statement has been drawn from these diverse sources and officers' own views.

1. Individual Forecasts

Sector: interest rate forecast – 6.1.11

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
Bank rate	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.25%	2.75%	3.00%	3.25%	3.25%
3 month LIBID	0.60%	0.70%	0.80%	1.00%	1.25%	1.50%	1.75%	2.00%	2.50%	3.00%	3.25%	3.50%	3.50%
6 month LIBID	0.90%	1.00%	1.10%	1.20%	1.50%	1.80%	2.10%	2.40%	2.80%	3.20%	3.50%	3.80%	4.00%
12 month LIBID	1.40%	1.50%	1.60%	1.80%	2.10%	2.40%	2.70%	3.00%	3.20%	3.40%	3.65%	4.00%	4.20%
5yr PWLB rate	3.30%	3.30%	3.40%	3.50%	3.60%	3.80%	3.90%	4.10%	4.30%	4.60%	4.80%	4.90%	5.00%
10yr PWLB rate	4.40%	4.40%	4.40%	4.50%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%	5.40%	5.40%
25yr PWLB rate	5.20%	5.20%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.60%	5.70%	5.70%
50yr PWLB rate	5.20%	5.20%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.60%	5.70%	5.70%

Capital Economics: interest rate forecast – 12.1.11

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.50%	2.00%
5yr PWLB rate	3.20%	3.20%	3.00%	2.75%	2.75%	2.90%	3.00%	3.20%	3.40%	3.60%	3.90%	4.20%
10yr PWLB rate	4.75%	4.75%	4.25%	3.75%	3.75%	3.75%	3.75%	3.75%	3.90%	4.00%	4.30%	4.60%
25yr PWLB rate	5.25%	5.25%	4.85%	4.65%	4.65%	4.65%	4.65%	4.65%	4.75%	4.85%	5.10%	5.30%
50yr PWLB rate	5.30%	5.30%	5.20%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.10%	5.20%	5.30%

UBS: interest rate forecast (for quarter ends) – 6.1.11

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
Bank rate	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%
10yr PWLB rate	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%
25yr PWLB rate	5.25%	5.30%	5.35%	5.40%	5.45%	5.50%	5.55%	5.60%
50yr PWLB rate	5.35%	5.40%	5.45%	5.50%	5.55%	5.60%	5.65%	5.70%

2. Survey of Economic Forecasts

HM Treasury December 2010

The current Q4 2010 and 2011 forecasts are based on the December 2010 report. Forecasts for 2010 – 2014 are based on 32 forecasts in the last quarterly forecast – in November 2010.

BANK RATE FORECASTS		quarter ended		annual average Bank Rate			
	actual	Q4 2011		ave. 2011	ave. 2012	ave. 2013	ave. 2014
Median	0.50%	2.00%		0.90%	1.60%	2.40%	3.00%
Highest	0.50%	0.50%		2.10%	3.10%	3.60%	4.50%
Lowest	0.50%	0.80%		0.50%	0.50%	0.60%	1.20%

APPENDIX 3

Prudential and Treasury Indicators

TABLE 5: PRUDENTIAL INDICATORS	2011/2012	2012/2013	2013/2014
Extract from budget and rent setting report	**estimate**	**estimate**	**estimate**
	£'000	**£'000**	**£'000**
Capital Expenditure			
Non - HRA	48,923	12,452	3,854
HRA (applies only to housing authorities)	5,572	6,705	5,060
TOTAL	54,495	19,157	8,914
Ratio of financing costs to net revenue stream			
Non - HRA	2.96%	2.82%	2.65%
HRA (applies only to housing authorities)	14.39%	13.92%	13.63%
Net borrowing requirement			
brought forward 1 April	93,013	89,032	132,804
carried forward 31 March	89,032	132,804	128,141
in year borrowing requirement	-3,980	43,772	-4,663
Capital Financing Requirement as at 31 March			
Non – HRA	209,543	201,845	195,464
HRA	22,013	37,613	37,613
TOTAL	231,556	239,455	233,077
Annual change in Cap. Financing Requirement			
Non – HRA	-165	-7,701	-6,378
HRA	735	15,600	0
TOTAL	570	7,899	-6,378
Incremental impact of capital investment decisions	**£ p**	**£ p**	**£ p**
Increase in council tax (band D) per annum	-9.46	-8.49	-8.30
Increase in average housing rent per week	1.35	3.14	2.46

TABLE 6: TREASURY MANAGEMENT INDICATORS	2011/2012	2012/2013	2013/2014
	estimate	estimate	estimate
	£'000	£'000	£'000
Authorised Limit for external debt -			
borrowing	414,212	420,701	411,485
other long term liabilities	8	8	8
TOTAL	414,220	420,709	411,493
Operational Boundary for external debt -			
borrowing	376,556	382,455	374,077
other long term liabilities	8	8	8
TOTAL	376,564	382,463	374,085
Actual external debt	163,325	153,312	143,312
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / investments	100%	100%	100%
Upper limit for variable rate exposure			
Net principal re variable rate borrowing / investments	40%	40%	40%
Upper limit for total principal sums invested for over 364 days (per maturity date)	£150,000	£150,000	£150,000

TABLE 7: Maturity structure of fixed rate borrowing during 2011/2012	upper limit	lower limit
under 12 months	50%	0%
12 months and within 24 months	50%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	50%	0%
10 years and above	100%	0%

Economic Background

Economic Background

4.1. Global economy

The sovereign debt crisis peaked in May 2010 prompted, in the first place, by major concerns over the size of the Greek government's total debt and annual deficit. However, any default or write down of Greek debt would have substantial impact on other countries, in particular, Portugal, Spain and Ireland. This crisis culminated in the EU and IMF putting together a €750bn support package in mid May. A second crisis, this time over Ireland in November, culminated in Ireland also having to take a bail out. At the time of writing (early January 2011) there is major concern that Portugal will also shortly need to take a bail out. That, in turn, would then stoke major concerns as to whether the current size of the bail out facility put together by the EU and IMF would be big enough to cope with any crisis that then blew up over Spanish government debt.

The unexpectedly high rate of growth in quarters 2 and 3 of 2010 in the UK and the Euro zone in Q2 were driven by strong growth in the construction sector catching up from inclement weather earlier in the year and by other short term factors not expected to be enduring; general expectations are for anaemic (but not negative) growth in 2011 in the western world.

4.2 UK economy

Following the general election in May 2010, the coalition government has put in place an austerity plan to carry out correction of the public sector deficit over the next five years. The result of fiscal contraction will be major job losses during this period, in particular in public sector services. This is likely to have a knock on effect on consumer and business confidence and appears to have also hit the housing market as house prices started on a generally negative trend starting in mid 2010. Mortgage approvals are also at very weak levels, all of which indicates that the housing market is likely to be weak in 2011.

Economic Growth – GDP growth is likely to have peaked in the current period of recovery at 1.2% in quarter 2 of 2010. Growth in quarter 3 @ +0.7% was also unexpectedly high. However, the outlook is for anaemic growth in 2011/12 although the Bank of England and the Office for Budget Responsibility are forecasting near trend growth (2.5%) i.e. above what most forecasters are currently expecting.

Unemployment – the trend of falling unemployment (on the benefit claimant count) has now been replaced since July 2010 with small increases which may be the start of a new trend for some years ahead of rising unemployment.

Inflation and Bank Rate – CPI has remained high during 2010. It peaked at 3.7% in April and then gradually declined to 3.1% in September (RPI 4.6%). However, the outlook from there is a rising trend which could even reach as much as 4% in early 2011 before starting to subside again. Although inflation has remained stubbornly above the MPC's 2% target, the MPC is confident that inflation will fall back under the target over the next two years.

The Bank of England finished its programme of quantitative easing (QE) with a total of £200bn in November 2009. However, major expectation that there could be a second round of quantitative easing in late 2010 or early 2011, to help support economic growth, has evaporated after the surprises of the Q3 GDP figure of +0.7% and the November Inflation Report revising the forecast for short term inflation sharply upwards.

Sector's central view is that there is unlikely to be any increase in Bank Rate until the end of 2011.

AAA rating – prior to the general election, credit rating agencies had been issuing repeated warnings that unless there was a major fiscal contraction, then the AAA sovereign rating was at significant risk of being downgraded. Sterling was also under major pressure during the first half of the year. However, after the Chancellor's budget on 22 June, Sterling strengthened against the US dollar and confidence has returned that the UK will retain its AAA rating. In addition, international investors viewed UK government gilts as being a safe haven from EU government debt during mid 2010. The consequent increase in demand for gilts helped to add downward pressure on gilt yields and PWLB rates.

4.3 Sector's forward view

It is currently difficult to have confidence as to exactly how strong UK economic growth is likely to be during 2011/2012, and there are a range of views in the market. Sector has adopted a moderate view. There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas:

- the strength / weakness of economic growth in our major trading partners - the US and EU
- the danger of currency war and resort to protectionism and tariff barriers if China does not adequately address the issue of its huge trade surplus due to its undervalued currency
- the degree to which government austerity programmes will dampen economic growth and undermine consumer confidence
- changes in the consumer savings ratio
- the speed of rebalancing of the UK economy towards exporting and substituting imports
- the potential, in the US, for more quantitative easing, and the timing of this , and its subsequent reversal in both the US and UK
- the speed of recovery of banks' profitability and balance sheet imbalances and the consequent implications for the availability of credit to borrowers
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy
- political risks in the Middle East and Korea

The overall balance of risks is weighted to the downside and there is some residual risk of a double dip recession and deleveraging, creating a downward spiral of falling demand, falling jobs and falling prices, although this is currently viewed as being a small risk.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

APPENDIX 5

Specified and Non-Specified Investments

SPECIFIED INVESTMENTS:

(All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' rating criteria where applicable)

	*** Minimum 'High' Credit Criteria**	**Use**
Debt Management Agency Deposit Facility	--	In-house and Fund Manager
Term deposits – local authorities	--	In-house and Fund Manager
Term deposits – banks and building societies	See note 1 and 2	In-house and Fund Manager
Banks nationalised by high credit rated (sovereign rating) countries	See note 1 and 2	In-house and Fund Manager
Government guarantee (explicit) on ALL deposits by high credit rated (sovereign rating) countries**	See note 1 and 2	In-house and Fund Manager
UK Government support to the banking sector (implicit guarantee) ***	See note 1 and 2	In-house and Fund Manager
Collateralised deposit (see note 3)	UK sovereign rating	In-house and Fund Manager
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	See note 1 and 2	In-house and Fund manager
Certificates of deposit issued by banks and building societies covered by the UK government banking support package (implicit guarantee)	See note 1 and 2	In-house and Fund Manager
Certificates of deposit issued by banks and building societies NOT covered by UK Government support package (implicit guarantee)	See note 1	In-house
Certificates of deposit issued by banks and building societies NOT covered by UK Government guarantee support package (implicit guarantee)	See Note 2	Fund manager
UK Government Gilts	UK sovereign rating	In-house buy and hold and Fund Manager
Bonds issued by multilateral development banks	AAA	In-house buy and hold and Fund Manager
Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government (refers solely to GEFCO - Guaranteed Export Finance Corporation)	UK sovereign rating	In-house buy and hold and Fund Manager
Sovereign bond issues (other than the UK govt)	AAA	In-house buy and hold and Fund Manager
Treasury Bills	UK sovereign rating	In house and Fund Manager
Government Liquidity Funds	* Long-term AAA volatility rating V1+	In-house and Fund Managers
Money Market Funds	* Long-term AAA volatility rating V1+	In-house and Fund Managers

Note 1. Award of "Creditworthiness" Colour by Sector Treasury services as detailed in paragraph 13.2 and appendix 10 TMP 1.1

Note 2. Inclusion within the Investec approved Counterparty list as detailed in paragraph 13.2 and appendix 10 TMP 1.1

Note 3. As collateralised deposits are backed by collateral of AAA rated local authority LOBOs, this investment instrument is regarded as a AAA rated investment as it is equivalent to lending to a local authority.

If forward deposits are to be made, the forward period plus the deal period should not exceed one year in aggregate.

N.B. buy and hold may also include sale at a financial year end and repurchase the following day in order to accommodate the requirements of SORP.

** e.g. Australia (AA+), Singapore (AAA), Hong Kong (AA); need to specify list of countries approved for investing with their banks

***The original list of banks covered when the support package was initially announced was: -

- Abbey (now part of Santander)
- Barclays
- HBOS (now part of the Lloyds Group)
- Lloyds TSB
- HSBC
- Nationwide Building Society
- RBS
- Standard Chartered

Banks eligible for support under the UK bail-out package and which have issued debt guaranteed by the Government are eligible for a continuing Government guarantee when debt issues originally issued and guaranteed by the Government mature and are refinanced. However, no other institutions can make use of this support as it closed to new issues and entrants on 28.2.10. The banks which have used this explicit guarantee are as follows: -

- Bank of Scotland
- Barclays
- Clydesdale
- Coventry Building Society
- Investec Bank
- Nationwide Building Society
- Rothschild Continuation Finance plc
- Standard Life Bank
- Tesco Personal Finance plc
- Royal Bank of Scotland
- West Bromwich Building Society
- Yorkshire Building Society

Accounting treatment of investments. The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, we will review the accounting implications of new transactions before they are undertaken.

NON-SPECIFIED INVESTMENTS: A maximum of 70% ** will be held in aggregate in non-specified investment

1. Maturities of ANY period

	* Minimum Credit Criteria	Use	** Max % of total investments	Max. maturity period
Fixed term deposits with variable rate and variable maturities: -Structured deposits	See note 1	In-house	£10m	Lower of 5 years or Sector duration rating

2. Maturities in excess of 1 year

	* Minimum Credit Criteria	Use	** Max % of total investments	Max. maturity period
Term deposits – local authorities	--	In-house	40%	5 Years
Term deposits – banks and building societies	See note 1	In-house	40%	As per Sector duration rating
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	See note 1 and 2	In-house and Fund manager	40%	As per Sector duration rating and see note 3
Certificates of deposit issued by banks and building societies covered by the UK government banking support package (implicit guarantee)	See note 1 and 2	In-house and Fund manager	40%	As per Sector duration rating and see note 3
Certificates of deposit issued by banks and building societies NOT covered by UK Government support package (implicit guarantee)	See note 1 and 2	In-house and Fund manager	40%	As per Sector duration rating and see note 3
UK Government Gilts	UK sovereign rating	In-house and Fund Manager	40% In-house 100% Investec	In-house see note 1, Investec see note 2
Bonds issued by multilateral development banks	AAA	In-house and Fund Manager	20% in-house 40% Investec	In-house see note 1, Investec see note 2
Sovereign bond issues (other than the UK govt)	AAA	In-house and Fund Manager	20% in-house 40% Investec	In-house see note 1, Investec see note 2

Note 1. Award of “Creditworthiness” Colour by Sector Treasury services as detailed in paragraph 13.2 and appendix 10 TMP 1.1

Note 2, Inclusion within the Investec approved Counterparty list as detailed in Section 13.2 and appendix 10 TMP 1.1

Note 3, Investec limits – Portfolio average to be up to 3 years, individual investments to a maximum of 10 years.

APPENDIX 6

Approved countries for investments

AAA

- Canada
- Denmark
- Finland
- France
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland
- U.K.
- U.S.A.

AA+

- Australia
- Belgium
- Hong Kong

AA

- Japan
- Kuwait
- Qatar (AA S&P rating)
- UAE (AA S&P rating)

AA-

- Italy
- Saudi Arabia