VALE OF WHITE HORSE DISTRICT COUNCIL Report No. 148/08
Wards Affected - ALL

REPORT OF THE STRATEGIC DIRECTOR
TO THE EXECUTIVE
6 FEBRUARY 2009

Treasury Management and Investment Strategy for 2009/10

1.0 Introduction and Report Summary

1.1 This report sets out the detailed treasury management strategy for 2009/10 and gives an indication of expected treasury operations for 2010/11 and 2011/12.

1.2 The prudential capital financing regime lays down four key legislative requirements:

- The reporting of the **prudential indicators** setting out the expected capital activities (as required by the CIPFA Prudential Code for Capital Finance in Local Authorities) forms part of the budget proposal considered by the Council in February;
- If the Council borrowed to fund capital expenditure it would need a **Minimum Revenue Provision (**MRP**) Policy**, which sets out how the Council will pay for capital assets through revenue each year. This is not applicable to this Council at the moment but if it was a report would be brought forward prior to the year in which it would happen;
- The **treasury management strategy statement** which sets out how the Council's treasury service will support the capital programme and revenue budget, the day to day treasury management and the limitations on activity through treasury prudential indicators. The Council has to agree some key indicators required by s3 of the Local Government Act 2003. This is in accordance with the CIPFA Code of Practice on Treasury Management and shown at Appendix A;
- The **investment strategy** which sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss. This strategy is in accordance with the CLG Investment Guidance, and also shown in Appendix A.

1.3 The Contact Officer for this report is Steve Lawrence, Principal Accountant (Technical), telephone (01235 540321), email steve.lawrence@whitehorsedc.gov.uk

2.0 Recommendations

2.1 Members are asked to recommend to Council to approve:

a) The Treasury Management Strategy 2009/10 to 2011/12, and the treasury Prudential Indicators contained within Appendix A.

b) The Authorised Limit Prudential Indicator.

c) The Investment Strategy 2009/10 contained in the treasury management strategy (Appendix A), and the detailed criteria included in Annex A1.

3.0 Relationship with the Council's Vision, Strategies and Policies

This report supports all objectives in the Council's vision, in that it complies with the Council's strategies for sound financial management. It also follows the procedure recommended in the revised CIPFA Treasury Management Code of Practice, January 2002.

4.0 Local Government Investments

4.1 Local Authorities' powers and practices for investing their surplus funds are contained in Part 1 of the *Local Government Act 2003.* The act allows the Secretary of State to issue guidance on investments and to specify other guidance which should be followed. Guidance was issued in March 2004 and specified that regard should also be had to the *Treasury Management Code of Practice* and *The Prudential Code for Capital Finance* issued by the Chartered Institute of Public Finance and Accountancy (CIPFA).

4.2 The general objective remains that local authorities should prudently invest surplus funds held. Priority should be given to security and liquidity but it is reasonable to seek the highest return consistent with those aims. The guidance specifically discourages the use of speculative investments such as equities. Borrowing to invest remains unlawful.

4.3 Somewhat confusingly the guidance introduces the concept of "specified" and "non-specified" cash investments. Specified investments are those offering high security, high liquidity and low risk. They should be in sterling and with a maturity of no more than 1 year. Investments made with the UK Government or a local authority are automatically included as are bodies with "a high credit rating", the definition of which is left to the authority. Non-specified investments are those that don't meet this description. The aim seems to be not to discourage authorities from using non-specified investments but to ensure that proper procedures are in place to assess any greater risk. These categories are further considered in annex A1of the Strategy.

4.4 The guidance also applies to investments made through external fund managers.

5.0 Treasury Management and Investment Strategy

5.1 The legislation requires an annual Treasury Management & Investment Strategy Statement. This sets borrowing limits, investment objectives, approved organisations for investment, guidelines and performance criteria for the in-house operation. There has been no significant change in the Council's circumstances but the current economic climate and difficulties in the money markets has prompted a review of approach. The result has been to maintain similar base criteria as in previous years but tailor it by:

- Implementing a more restrictive operational strategy than that set out until such time as the banking system returns to "normal" operations. (This has been the actual practice since October 2008). This will allow the investment service to return to the fuller criteria without a further Council resolution.
- Including those institutions with wholesale guarantees where the government has a sovereign 'AAA' rating from all 3 main rating agencies. Any investments would be limited to amounts and maturities within the terms of the guarantee.

5.2 The proposed Strategy Statement for 2009/10 is set out at Appendix A. The basic criteria are very similar to the 2008-09 strategy but some additional information has been included.

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Background Papers:

CIPFA – Code of Practice on Treasury Management.
CLG - Guidance on Local Government Investments.
Butlers – Capital Watch information sheet published 4 December 2008

Treasury Management Strategy 2009/10 – 2011/12

1. The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators that will be included in the budget proposal consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures the Council meets balanced budget requirement under the Local Government Finance Act 1992. There are specific treasury prudential indicators included in this strategy which require approval.

2. The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). This Council adopted the current Code of Practice on Treasury Management in March 2002. This adoption meets the requirements of the first of the treasury prudential indicators.

3. The policy requires an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming year. 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.

4. This strategy covers:
   - The Council's debt and investment projections;
   - The Council's estimates and limits on future debt levels;
   - The expected movement in interest rates;
   - The Council's borrowing and investment strategies;
   - Treasury performance indicators;
   - Specific limits on treasury activities;
   - Any local treasury issues.

Debt and Investment Projections 2009/10 – 2011/12

5. The Council has to detail its borrowing requirement, any maturing debt which will need to be re-financed, and the effect this will have on the treasury position over the next three years. This Council has no external debt and doesn't expect to borrow except temporarily for cash flow purposes. The table therefore only specifies the limits for any likely temporary borrowing and highlights the expected change in investment balances.

£m	2008/09 Revised	2009/10 Estimated	2010/11 Estimated	2011/12 Estimated
External Debt				
Operational boundary	£2 million	£2 million	£2 million	£2 million
Authorised limit	£5 million	£5 million	£5 million	£5 million
Limit at variable interest rates	nil	nil	nil	nil
Limit for maturity > 1 year	nil	nil	nil	nil
Investments				
Total Investments at 31 March	£15 m	£15 m	£15 m	£15 m

The following information has been provided by Butlers, the Council's investment advisers.

Expected Movement in Interest Rates

Annual Average %	Bank Rate	Money Rates	
		3 month	1 year
2008/09	3.9	5.0	5.3
2009/10	1.0	1.6	1.8
2010/11	1.7	2.1	2.8
2011/12	2.4	2.8	3.6

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

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

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

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

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

Investment Counterparty and Liquidity Framework

11. The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:
    - It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.
    - It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

12. The Strategic Director will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. This criteria is separate to that which chooses Specified and Non-Specified investments as it selects which counterparties the Council will choose rather than defining what its investments are. The rating criteria use the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria.
    - Banks 1 **– the Council will use banks which have at least the following Fitch, Moody's and Standard and Poor's ratings (where rated):**
    - Short Term – F1 P-1 A-1 (Fitch/Moody/S&P)
    - Long Term – A- A3 A
    - Individual / Financial Strength – C (Fitch / Moody's only)
    - Support – 3 (Fitch only)
    - Banks 2 – **In addition, the Council will use banks** whose ratings fall below the criteria specified above if all of the following conditions are met (a) wholesale deposits in the bank are covered by a government guarantee; (b) the government providing the guarantee is rated "AAA" by all three major rating agencies (Fitch, Moody's and Standard & Poor's); and (c) the Council's investments with the bank are limited to amounts and maturities within the terms of the stipulated guarantee.
    - Bank Subsidiary and Treasury Operations **– the Council will use these where the parent bank has the necessary ratings outlined above.**
    - Building Societies **– the Council will use Societies with assets in excess of £500 million.**
    - Money Market Funds – AAA
    - UK Government (including gilts and the DMADF)
    - Local Authorities, Parish Councils etc
    - Supranational institutions

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

Ratings short term/long term	Fitch	Moody's	Standard & Poor's	Money Limit	Time Limit
Upper Limit Category	F1+/AA-	P-1/Aa3	A-1+/AA-	£5m	3 yrs
Lower Limit Category	F1/A-	P-1/A3	A-1/A-	£5m	1 yr
Other Institution Limits	-	-	-	£5m	3 yrs
Guaranteed Organisations	-	-	-	£5m	various

(The Upper Limit category will include banks and building societies. The Lower Limit category will normally be used for unrated subsidiaries and unrated building societies. The Other Institution Limit will be for other local authorities, the DMADF, Money Market Funds and Gilt and Supranational investments. These are all considered high quality names – although not always rated – and therefore will likely have the same limit as the Upper Category. Guaranteed institutions will need to be restricted to the terms of the guarantee.)
In exceptional circumstances short term variations to these limits will be allowed, subject to the written authority of the Strategic Director.

14. The proposed criteria for Specified and Non-Specified investments are shown in Annex A1.

15. 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.

16. 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 investment prudential indicator below.

Investment Strategy 2009/10 – 2011/12

17. Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of the current 1.5% Bank Rate (at 15 Jan) reducing even further. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts.

18. There is a clear operational difficulty arising from the current banking crisis. Ideally investments would be invested longer for better returns, however doubts on counterparty creditworthiness suggests shorter dated investments would provide better security.

19. **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, under the exceptional current market conditions the Strategic Director will temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria approved. These restrictions will remain in place until the banking system returns to "normal" conditions. Similarly the time periods for investments will be restricted.**

20. Examples of these restrictions might include the greater use of the Debt Management Deposit Account Facility (DMADF – a Government body which accepts local authority deposits), Money Market Funds, guaranteed deposit facilities and strongly rated institutions offered support by the UK Government. The credit criteria has been amended to reflect these facilities.

Sensitivity to Interest Rate Movements

21. Future Council accounts will be required to disclose the impact of risks on the Council's treasury management activity. Whilst most of the risks facing the treasury management service are addressed elsewhere in this report (credit risk, liquidity risk, market risk, maturity profile risk), the impact of interest rate risk is discussed but not quantified. The table below highlights the estimated impact of a 1% increase/decrease in all interest rates to treasury management income for next year. Similar figures are expected to be shown for costs i.e. interest on borrowing but the Council has no debt.

Interest rate variance	**2009/10 Estimated + 1%**	**2009/10 Estimated - 1%**
Revenue Budget variance £ m		
Investment income	+ £0.301 m	- £0.300 m

Treasury Management Prudential Indicators and Limits on Activity

22. There are four further treasury prudential indicators. The purpose of these prudential indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to generate income. At this Council, with no debt, these indicators apply only to investments. They are:

- Upper limits on variable interest rate exposure – With the level of operation at this Council we have not felt the need to use period investments at variable interest rates. Currently an instant access bank deposit account is used for "overnight" investment. The interest rate is revised every week by the bank but we could move our funs at any time.
- Upper limits on fixed interest rate exposure – Similar to the previous indicator this covers a maximum limit on fixed interest rates.
- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing. As previously stated this does not apply here.
- Total principal funds invested for greater than 364 days – These limits are set to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

These limits, which include cash held by the fund Manager, are higher than the Council's actual total funds because cash received during the year is invested until it is paid over to the Government or to precepting bodies.

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

£m	2009/10	2010/11	2011/12
Interest rate Exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates: • Debt only • Investments only	 nil £50 m	 nil £50 m	 nil £50 m
Limits on variable interest rates • Debt only • Investments only	 nil £10 m	 nil £10 m	 nil £10 m
Maturity Structure of fixed interest rate borrowing 2009/10 – not applicable			
Maximum principal sums invested > 364 days			
Principal sums invested > 364 days	£20 m	£20 m	£20 m

Performance Indicators

24. 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 that we use are:

- Investment returns above the 7 day LIBID rate (in-house and Fund Manager).
- Investment returns compared to similar local authority funds (FM only). Target is to be in the top quartile.
- Full investment of daily balances (in-house only).
- Maintenance of a balanced portfolio.

The results of these indicators will be reported in the annual Treasury Management Report.

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

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

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 has adopted the Code and will apply its principles to all investment activity. This part, TMP 1(5), covering investment counterparty policy requires approval each year.

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

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

This strategy is to be approved by full Council.

The investment policy proposed for the Council is:

Strategy Guidelines – The main strategy guidelines are contained in the body of the treasury strategy statement.

Specified Investments – These 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) and not defined as capital expenditure (making an investment in a company). These are low risk assets where the possibility of loss of principal or investment income is small. These would include investments with:

1. The UK Government (such as the Debt Management Account deposit facility, UK Treasury Bills or a Gilt with less than one year to maturity).
2. Supranational bonds of less than one year's duration.
3. A local authority, parish council or community council.
4. Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency.

5. A body that has been awarded a high credit rating by a credit rating agency (such as a bank or building society although non-rated subsidiaries and low or non-rated building societies will need to be non-specified investments.)
6. A body which has been provided with a government issued guarantee for wholesale deposits within specific timeframes. Where these guarantees are in place and the government has an AAA sovereign long term rating these institutions will be included within the Council's criteria temporarily until such time as the ratings improve or the guarantees are withdrawn. Monies will only be deposited within the timeframe of the guarantee.

For category 4 this covers pooled investment vehicles, such as money market funds, rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.

For category 5 this covers bodies with a minimum rating of F1+ (or the equivalent) as rated by Fitch, Moody's, or Standard and Poor's rating agencies. Within these bodies, and in accordance with the Code, the Council has set additional criteria for the time and amount of monies which will be invested in any of these bodies. This criteria is 3 years and £5 million

Non-Specified Investments – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Bonds and Gilt-edged securities are included for the benefit of the Council's Fund Manager. Non specified investments would include any sterling investments with:

	Non Specified Investment Category	Limit £ or %
a.	**Supranational Bonds greater than 1 year to maturity** **(a) Multilateral development bank bonds** - These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Investment Bank etc.). **(b) A financial institution that is guaranteed by the United Kingdom Government** (e.g. The Guaranteed Export Finance Company {GEFCO}) The security of interest and principal on maturity is on a par with the Government and so very secure, and these bonds usually provide returns above equivalent gilt edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	Any one name up to 20% of the value of the fund.
b.	**Gilt edged securities** with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity. Average duration of investments for fund should not exceed 5 years.	Maximum proportion of fund invested for longer than 1 year not to exceed 60%
c.	**Building societies not meeting the basic security requirements under the specified investments**. The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings. The council may use such	

	building societies which have a minimum asset size of £1 billion, restricted to 1 year, and minimum asset size of £500 million restricted to 6 months.	Each £3 million
d.	Any **bank or building society** that has a minimum long term credit rating of AA- or equivalent, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	Maximum limit of 50%
e.	Any **non rated subsidiary** of a credit rated institution included in the specified investment category. These institutions will be included as an investment category subject to a guarantee from the parent company, and a maximum period of investment of 6 months.	£3 million

The Monitoring of Investment Counterparties - The credit rating of counterparties will be monitored regularly. The Council receives credit rating information from Butlers on a daily basis, 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 and if required new counterparties which meet the criteria will be added to the list.

Use of External Fund Managers – It is the Council's policy to use an external fund manager for part of its investment portfolio. The fund manager will use both specified and non-specified investment categories, and is contractually committed to keep to the Council's investment strategy. The performance of each manager is reviewed quarterly and annually.