

ITEM

ITEM

Scrutiny – 19 March 2009

TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY 2009/10

Report of the Head of Financial Services

Statutory Powers:

Local Government Act 2003

Financial Implications:

Interest from our investments is estimated to amount to £930,000 in 2009/10.

Purpose:

To advise Members of the Council's Treasury Management Strategy and to consider the prudential indicators and limits set out within the report, in accordance with the Prudential Framework. Consideration of this item relates to CP6 – "Improve core service performance in a cost effective way".

RECOMMENDATION

That Scrutiny resolves to note the report and identify any observations they would like the Council to consider when they next review the strategy.

Background:

In light of the request by Scrutiny to consider the Council's Investment and Income Strategy, a report is presented to Members which was also considered by the Executive at its 22 January 2009 meeting (Minute E.103/08 refers and the content of this minute is attached at Appendix E for information).

1 INTRODUCTION

- 1.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management 2001 was adopted by this Council on 2nd May 2002 and this Council fully complies with its requirements.
- 1.2 CIPFA defines the objectives of Treasury Management in Local Authorities as:

“The management of the local authority’s 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. ”

- 1.3 The Local Government Act 2003 and supporting regulations requires the Council to ‘have regard to’ the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council’s capital investment plans are affordable, prudent and sustainable.
- 1.4 The Act therefore requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance issued subsequent to the Act); this sets out the Council’s policies for managing its investments and for giving priority to the security and liquidity of those investments.
- 1.5 The suggested strategy for 2009/10 in respect of the following aspects of the treasury management function is based upon the latest information on interest rates. The strategy covers:
 - treasury limits in force which will limit the treasury risk and activities of the Council;
 - the current treasury position;
 - the borrowing requirement;
 - prospects for interest rates;
 - the investment policy and strategy;
 - Prudential Indicators;

2 CURRENT INVESTMENT PORTFOLIO POSITION

- 2.1 The Council’s current treasury portfolio as at 9th January 2009 is shown in the following table.

Investments	Principal (£)	Average Interest Rate %
Short Term, less than 1 year	13,030,000	0.9
More than one year	15,000,000	6.2
Total Investments	28,030,000	3.7

- 2.2 However, the impact of normal cash flow requirements will result in a reduction in the investment balance from this date to £19million at the end of the financial year.
- 2.3 This authority currently has a £1.25million investment frozen in the Heritable Bank which is UK registered and regulated but a subsidiary of one of the Icelandic Banks that have been affected by the world economic crisis. The deposit was due back on 22 December and we

have not yet been informed when the Administrators will be in a position to settle creditor's claims. They have said that their initial investigations indicate that the liabilities are broadly equal to the assets; a statement that the Local Government Association regard as positive. The Administrators have promised that a further update on the financial position will be made very early in 2009.

- 2.4 The Icelandic Government has stated its intention to honour all its commitments as a result of their banks being placed into receivership. The U.K. Government is working with the Icelandic Government to help bring this about. At the current time it is not possible to say with certainty that we will recover the entirety of our investment(s) or when reimbursements will be made to this authority.
- 2.5 The Local Government Association is coordinating the efforts of all UK authorities with Icelandic investments. Members will be periodically updated on the latest developments on these efforts.
- 2.6 The Government informed local authorities in November 2008 that it intends to make a regulation to require local authorities to delay recognising any loss on these investments that may eventually be incurred until the financial year 2010-11.

3 BORROWING REQUIREMENT

- 3.1 It is anticipated that there will be no capital borrowings required during 2009/10.

4 PROSPECTS FOR INTEREST RATES

- 4.1 The Council has appointed Sector Treasury Services as treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. The following paragraphs provide a summary of what has happened in the past year and outlines the economic factors that have been taken into account in formulating their advice on interest rates.

4.2 ECONOMIC BACKGROUND

Introduction

- The sub prime banking crisis of early 2008 was supplanted by the banking crisis of autumn 2008. The world banking system came near to collapse and governments around the world were forced to recapitalise and rescue their major banks. The resulting dearth of lending from banks anxious to preserve capital led to economic forecasts being sharply reduced and recession priced into markets. This in turn led to sharp falls in oil and other commodity prices with the result that inflation, which in the UK was running at over 5%, became yesterday's story and recession fears drove interest rate sentiment and policy. Commentators have described the present global economic situation as the worst economic crisis in living memory.

4.3 UK

- Growth slowed across the economy and unemployment rose throughout the year with forecasts of 2 million unemployed by the end of the financial year and continuing to increase thereafter through 2010.
- Bank lending came to a virtual standstill in the autumn as the credit crunch tightened its grip and various banks internationally had to be rescued, or supported, by their governments.
- The Government took action in September to either supply finance itself to recapitalise some of the major clearing banks or to require the others to strengthen their capital ratios by their own capital raising efforts. The intention was that banks would be seen to have sufficient reserves to last through the coming recession with its inevitable increase in bad loans etc.
- The housing market also came to a virtual standstill as lenders demanded larger deposits and higher fees. House sales and prices both dropped sharply.
- Government finances deteriorated as income from taxation dropped as the economy slowed and the cost of the bailout of the banks was added to the deficit.
- The story of 2008 has been the credit crunch, the banking crisis and the change in economic outlook from slow growth to outright recession. After the initial concerns about the impact of the credit crunch in the earlier part of 2008 it appeared as though the storm had been weathered. The Monetary Policy Committee (MPC) had been very concerned about CPI inflation, which had been rising sharply on the back of higher commodity and food prices. Bank Rate reached a peak of 5.75% in July 2007 after which cuts of 0.25% occurred in December 2007, February and April 2008 before the major cuts in the autumn 2008. The economic data had been indicating a slowing economy for some while but it was not sufficiently weak to force the MPC into another cut. It was the strength of the banking crisis, pre-empted by the collapse of Lehmans in New York that eventually drove the MPC to cut interest rates by 0.5% on October 8th in concert with the Federal Reserve, the European Central Bank (ECB) and other central banks. It was then appreciated that the economic downturn would be much more severe than previously thought and interest rates were subsequently slashed by 1.5% on 6 November, 1.0% on 4 December and 0.5% on 8 January 2009.
- The Government has abandoned its 'golden rule'. The pre Budget Report on 14 November revealed the Government's plans for a huge increase in Government borrowing over coming years as a result of falling tax revenues and also due to tax cuts and increases in Government expenditure in the short term designed to help stimulate economic growth to counter the recession.

4.4 International

- Early in 2008 the US economy was being badly affected by the

housing market slump. Interest rates were at 2% and inflation was being dragged higher by the inexorable rise in commodity prices. The ECB was very concerned about rising inflation and less about the state of the economy.

- The second quarter of 2008/9 was torn between inflation worries on the one hand, with oil rising towards \$150 per barrel, and the deteriorating economic outlook on the other.
- In the second and third quarters of the year the financial crisis erupted and escalated as the world became aware of the extent of the sub-prime crisis and the impact it was having on institutions that had invested in these issues.
- Then in mid September, Lehman Bros., the investment bank, was allowed to fail. This triggered a domino effect with other banks and financial institutions having to be rescued or supported by governments around the world.
- After the collapse into receivership of the Icelandic banks in early October, other countries then started to feel the strain and a number had to approach the IMF for support.
- Eventually even the Asian 'Tiger' economies were affected, including India and China, and it became clear that the crisis had become a global one and no country was insulated from it.
- The financial crisis had therefore precipitated an economic crisis and there was a co-ordinated global interest rate cuts. Inflation was yesterday's problem.

It is clear that globally the world's major economies are not just facing cyclical slowdown but a period, perhaps a prolonged one, of structural adjustment.

4.5 Sector's current interest rate view is shown in the table below and it predicts that Bank Rate will: -

- fall from current levels because of the intensifying global recession
- Starting 2009 at 2.00%, Bank Rate is forecast to fall to 0.5% in Q1 2009
- It is then expected to remain there until starting to rise gently up from Q2 2010 till it reaches 4.0% in Q1 2012.
- There is downside risk to these forecasts if the recession proves to be deeper and more prolonged than currently expected.

	Q/E1 2009	Q/E2 2009	Q/E3 2009	Q/E4 2009	Q/E1 2010	Q/E2 2010	Q/E3 2010	Q/E4 2010	Q/E1 2011	Q/E2 2011	Q/E3 2011	Q/E4 2011	Q/E1 2012
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.75%	2.50%	3.25%	3.75%	4.00%
5yr PWLB rate	2.50%	2.25%	2.15%	2.15%	2.15%	2.45%	2.80%	3.15%	3.65%	3.95%	4.20%	4.45%	4.60%
10yr PWLB rate	3.10%	2.75%	2.55%	2.55%	2.55%	2.85%	3.25%	3.65%	4.15%	4.40%	4.70%	4.75%	4.85%
25yr PWLB rate	4.00%	3.95%	3.95%	3.95%	4.00%	4.15%	4.35%	4.45%	4.60%	4.85%	4.95%	5.00%	5.05%
50yr PWLB rate	3.85%	3.80%	3.80%	3.80%	3.85%	3.90%	4.00%	4.25%	4.40%	4.70%	4.80%	4.95%	5.00%

4.6 Sector recommend the following interest rates be used for budget purposes:

2009/10: 1.5%
2010/11: 2.0%
2011/12: 3.5%

5 ANNUAL INVESTMENT STRATEGY

- 5.1 The Council will have regard to the Office of the Deputy Prime Minister Guidance on Local Government Investments (“the Guidance”) issued in March 2004 and CIPFA’s Treasury Management in Public Services Code of Practice. The Council’s investment priorities are: -
- (a) the security of capital and
 - (b) the liquidity of its investments.
- 5.2 The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security risk and liquidity.
- 5.3 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.
- 5.4 The Council uses Fitch and Moody’s credit ratings to derive its counterparty criteria. All credit ratings will be monitored daily. Appendix A explains the different ratings used by the agencies. They fall into two categories covering long term and short term investments. The long term ratings are opinions of the relative credit risk of fixed income obligations with an original maturity of one year or more. They address the possibility that a financial obligation will not be honoured as promised. Such ratings reflect both the likelihood of default and the probability of a financial loss suffered in the event of default.
- 5.5 Short term ratings are opinions of the ability of institutions to honour short term financial obligations. Such obligations generally have an original maturity not exceeding thirteen months, unless explicitly noted.

- 5.6 The Council is alerted to changes in ratings through its use of the Sector creditworthiness service and for 2009/10 it is proposed that:
- 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.
 - If a body is placed on negative rating watch (i.e. there is a reasonable probability of a rating change and the likelihood of that change being negative) then no further investments will be made with that body until the ratings watch has been lifted and its credit rating has been reconfirmed.
- 5.7 Since October 2008 we have used an ultra cautious investment strategy to avoid the possibility of potential losses. However, this has come at a cost; investing in virtually risk free institutions; namely the UK Government and Local Authorities means that we must accept a much lower interest rate on our investments.
- 5.8 We opened an account with the UK Governments' Debt Management Office (DMO) which currently pays interest rates of approximately 2% below money market rates. Where possible we have also used Local Authorities but this market is very limited and the rates are also substantially below market rates.
- 5.9 Using the new DMO account is a major issue in the long term; our average level of investments in 2008/09 is some £26m; if we were to only invest in the virtually risk free DMO account we would receive £520,000 per annum less interest than if we invested in the money market. £520,000 is equivalent to £14 (11%) on an average band D property. To replace this lost income would require other increases in charges or reduced services. Therefore it will require a balanced view to be taken about which institutions and what types of investments to make, taking into account risk and investment returns.
- 5.10 At one extreme Members can adopt a near risk free investment strategy and only use investments in the UK Government and local authorities. A slightly more risky approach but one that will provide a fairly low degree of risk is to raise the minimum level of the counterparty credit rating and explore other types of investments.
- 5.11 In the past we have set the minimum long term credit rating for banks at A, a short term rating of F1 and invested up to £5million for periods of up to 5 years. For Building Societies we have relied on their asset size because they are not rated and invested up to £5million for up to 5 years. It is recommended that the policy could be changed to minimum credit rating of AA- or F1+ for all UK banks and building societies with a maximum investment of £2.5million for up to 3 months. We have been operating to this standard since October 2008, however, it must be recognised this significantly reduces our counterparty list from over 100 to 10. To date this has meant it has been very difficult to place monies through the interbank market. This situation may improve if and when

banks start lending again. A list of the banks and building societies that currently meet the proposed minimum credit ratings are attached in Appendix C.

- 5.12 Other types of investments can be used namely UK Government Gilts which are virtually 100% risk free if held to maturity. It is also prudent to assess the risk of using Money Market Funds and Government Liquidity Funds. Both these types of fund are AAA rated our financial advisor, Sector, are recommending risk averse authorities to consider them. The purpose behind these funds is to offer a secure, liquid investment that will offer a higher return than investments such as the Debt Management Office account but will still give high credit quality.
- 5.13 There are three underlying principles to Money Market Funds; Security, Liquidity and Yield. The Guidance issued by the Government under S19 of the Local Government Act 2003 recommends that priority be given to security and liquidity. Nevertheless, it will be appropriate to seek the highest rate of return consistent with proper levels of security and liquidity. The general objective is that the authorities should prudently invest the surplus. Money Market Funds address all three of these principles and meet the guidelines' objectives. They have high security - AAA and liquid – with daily access.
- 5.14 However, it must be noted that Money Market Funds' underlying assets e.g. Gilts, Certificates of Deposits and bonds are subject to capital fluctuations. The movements in capital are as a result of interest rate risk and credit risk. However, the structure of the fund minimises the movement of capital value due to the restrictions laid down by the credit rating agencies.
- 5.15 It is therefore recommended that UK Government Gilts, Money Market Funds and Government Liquidity Funds be added to our list of investment instruments and used if the level of risk is assessed as very low.
- 5.16 Investment instruments and counterparty limits identified for use in the financial year are listed in Appendix B under the 'Specified' and 'Non-Specified' Investments categories laid down by Government regulations. Specified investments have a maturity of less than one year, whereas non specified investments can be made for periods of more than one year and can therefore be subject to more risk.
- 5.17 Since the credit crunch crisis there have been a number of developments which require separate consideration and approval for use: -
- 5.18 **Blanket guarantees on all deposits** - Some countries have supported their banking system by giving a blanket guarantee on ALL deposits e.g. Ireland. Authorities may view that the sovereign rating of that country then takes precedence over the individual credit ratings for the banks covered by that guarantee. We need to decide if we wish to rely

- on these blanket guarantees to authorise lending to banks covered by these guarantees and for which countries they are prepared to do so. It is recommended at the present time we do not invest in these countries because the sovereign country may not have a large enough economy to support all of their banks. Indeed it is doubtful if the UK Government could support a complete collapse of our banking system.
- 5.19 We will also need to decide if we wish to rely on this implicit guarantee for the banking systems of other countries. The US, countries within the EU and Switzerland (and other countries) are currently providing major support packages to their banking systems. Again, it is recommended at the present time we do not invest in these countries because the sovereign country may not be able to honour the total of its commitments.
- 5.20 **Nationalised banks** in the UK have credit ratings which do not conform to the credit criteria usually used by local authorities to identify banks which are of high credit worthiness. In particular, as they no longer are separate institutions in their own right, it is impossible for the rating agencies to assign them an individual rating for their stand alone financial strength. Accordingly, they have assigned a long term F rating which means that at a historical point of time, this bank failed and is now owned by the Government. However, these institutions are now recipients of an F1+ short term rating as they effectively take on the creditworthiness of the Government itself i.e. deposits made with them are effectively being made to the Government.
- 5.21 **UK banking system support package** - The UK Government has NOT given a blanket guarantee on all deposits but has underlined its determination to ensure the security of the UK banking system by supporting eight named banks with a £500bn support package. Again, we need to decide if we wish to authorise lending to those named banks on the basis of that implicit guarantee on local authority deposits placed with these eight banks or to rely on the credit ratings of the individual banks.
- 5.22 Banks supported by the UK bail-out package: -
- Abbey
 - Barclays
 - HBOS
 - Lloyds TSB
 - HSBC
 - Nationwide Building Society
 - RBS (including National Westminster Bank)
 - Standard Chartered
- 5.23 It is recommended that if the above banks maintain our minimum credit rating criteria that they be used for deposits for a period of up to three months. The exception being Lloyds TSB and HBOS which is still in the process of being merged and there is some doubt about the impact of

the liabilities of the HBOS pension fund.

- 5.24 Due to the uncertainty in the banking sector and to minimise any risk to the Council it is recommended that we do not invest for periods of longer than three months except in the UK Government and other local authorities. In any case we should avoid locking into longer term deals while investment rates are down at historically low levels, which is forecast to be some time to come.
- 5.25 It is also recommended that the maximum amount invested with any institution be limited to £2.5million (except UK Government).
- 5.26 The state of the economy and the creditworthiness of the banks is constantly changing. Treasury officers will therefore constantly monitor the situation by taking advice from our advisors, Sector and using media reports to change our investment practices if necessary. During the year it is proposed to update the Executive quarterly on the latest news of our investment with the Heritable Bank and all other aspects of the Treasury Management function. At the end of the financial year, we will report on our investment activity as part of its Annual Treasury Report.

6 PRUDENTIAL INDICATORS AND TREASURY LIMITS FOR 2009/10 TO 2011/12

- 6.1 It is a statutory duty under S.3 of the Local Government Act 2003 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 section 3 of the Local Government Act 2003.
- 6.2 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 is 'acceptable'.
- 6.3 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 leasing. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.
- 6.4 The setting of prudential indicators for treasury management requires authorities to recognise key implications of their borrowing and investment strategies. This has broadly three aspects: the exposure the risk of interest changes, the exposure inherent in the maturity structure of borrowings, and the risks associated with longer term investment. The indicators will integrate both borrowing and investments since both form part of an integrated treasury management strategy that seeks to

- minimise risk.
- 6.5 The treasury management indicators are not targets to be aimed at but are instead limits within which the treasury management policies of the authority are deemed to be prudent.
- 6.6 In accordance with the Prudential Code, the annual treasury management strategy incorporates a statement of the Council's proposed Treasury Management Indicators of Prudence, as shown in Appendix D.

7 MINIMUM REVENUE PROVISION

- 7.1 **What is a Minimum Revenue Provision?** - Capital expenditure is generally expenditure on assets which have a life expectancy of more than one year e.g. buildings, vehicles, machinery etc. It would be impractical to charge the entirety of such expenditure to revenue in the year in which it was incurred therefore such expenditure is spread over several years so as to try to match the years over which such assets benefit the local community through their useful life. If the Council borrows to finance the capital expenditure the manner of spreading these costs is through an annual Minimum Revenue Provision (MRP).
- 7.2 **New 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.”
- 7.3 The above is a substitution for the previous requirement to comply with regulation 28 in S.I. 2003 no. 3146, (as amended) which prescribed how the MRP should be calculated in a prescribed manner.
- 7.4 There is no requirement to charge MRP where the Capital Financing Requirement (CFR) is nil or negative at the end of the preceding financial year. The CFR is the measure of an authority’s outstanding debt liability as depicted by their balance sheet.
- 7.5 As the Council does not have any borrowing and has a negative CFR then there is no requirement to calculate the MRP.

8 RISK ANALYSIS

- 8.1 This whole report deals with the different risks and opportunities associated with the various aspects of Treasury Management and the Prudential Code. Specific risks are summarised below:

Opportunities/Benefits	
<p>Consideration of the Annual Treasury Strategy and setting of Prudential indicators forms an essential component of the Council's systems for public accountability. It also provides a platform for future investment planning.</p>	
Issues/Obstacles/Threats	Control measures / Mitigation
<p>Investments:</p> <ul style="list-style-type: none"> • risk of failure of counterparty • advancing monies to the wrong counterparty • failure to make advance when contracted to do so • liquidity constraints affecting interest rate performance • volatility of interest rates / inflation • day to day management fault resulting in overdrawn above agreed limits 	<p>The Council has adopted the CIPFA Code Of Practice for Treasury Management and produces an annual Treasury Management Statement and Investment Strategy in accordance with Government guidelines. The Council employs a Treasury Management advisor and a prudent view is always taken regarding future interest rate movements. Investment interest income is reported monthly to SMT and quarterly to the Executive.</p> <p>Credit risk and transaction or fraud risk are managed largely through procedural requirements and internal controls. Long term interest rate risk can be effectively measured and managed in terms of the maturity profile.</p>
<p>Capital expenditure and Income:</p> <ul style="list-style-type: none"> • Unanticipated major capital costs. • The availability and timing of capital receipts, grants and external contributions 	<p>The established practice of monitoring capital expenditure against estimates. Significant variation, for example caused by major overruns of expenditure on projects is acted upon and explained to Members through quarterly reports to the Executive, or ad hoc reports as necessary.</p> <p>Undertaking an annual review of available capital resources and budget pressures, to ensure effective prioritisation.</p> <p>Formalising existing treasury and capital monitoring by reporting against the key prudential indicators outlined above. Indicators will be monitored through the revenue and capital monitoring process and exceptions reported to the Executive together with any remedial action or revisions required.</p>

9 CONCLUSION

- 9.1 The security of investments and the income generated by Treasury Management activity are vitally important to the Council. Income from investments is estimated to total £930,000 in 2009/10, equivalent to approximately £25 for the average Band D council tax. This strategy sets out how we will approach the task of managing our investment activity in the forthcoming financial year during what promises to be a very difficult economic period. It attempts to maximise the income from investments, subject to the overriding management of risks, with risk limitation being more important than investment return.

John Foxworthy
Head of Financial Services

Scrutiny
19 March 2009

Mark Seymour
Strategic Director (Resources)

Background Documents:
None

Key to credit ratings

Fitch

Long-term Credit Ratings

Fitch's long-term credit ratings are set up along a scale from 'AAA' to 'D', have been adopted and licensed by S&P. Moody's also uses a similar scale, but names the categories between AA and CCC (i.e., AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB- etc.).

We have defined the investment grade rating below but the ratings go as low as DDD.

Investment Grade

- **AAA:** the best quality companies, reliable and stable
- **AA:** quality companies, a bit higher risk than AAA
- **A:** economic situation can affect finance
- **BBB:** medium class companies, which are satisfactory at the moment

Short Term

Fitch's short-term ratings indicate the potential level default within a 12-month period.

- **F1+:** best quality grade, indicating exceptionally strong capacity of obligor to meet its financial commitment
- **F1:** best quality grade, indicating strong capacity of obligor to meet its financial commitment
- **F2:** good quality grade with satisfactory capacity of obligor to meet its financial commitment
- **F3:** fair quality grade with adequate capacity of obligor to meet its financial commitment but near term adverse conditions could impact the obligor's commitments
- **B:** of speculative nature and obligor has minimal capacity to meet its commitment and vulnerability to short term adverse changes in financial and economic conditions
- **C:** possibility of default is high

Moody's ratings

Long-term obligation ratings

Moody's long-term obligation ratings are opinions of the relative credit risk of fixed-income obligations with an original maturity of one year or more. They address the possibility that a financial obligation will not be honoured as promised. Such ratings reflect both the likelihood of default and the probability of a financial loss suffered in the event of default.

Investment grade

Aaa – Obligations rated Aaa are judged to be of the highest quality, with the “smallest degree of risk”.

Aa1, Aa2, Aa3 – Obligations rated Aa are judged to be of high quality and are subject to very low credit risk, but “their susceptibility to long-term risks appears somewhat greater”.

A1, A2, A3 – Obligations rated A are considered upper-medium grade and are subject to low credit risk, but that have elements “present that suggest a susceptibility to impairment over the long term”.

Baa1, Baa2, Baa3 – Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such “protective elements may be lacking or may be characteristically unreliable”.

Short-Term Ratings

Moody's short-term ratings are opinions of the ability of issuers to honour short-term financial obligations. Such obligations generally have an original maturity not exceeding thirteen months, unless explicitly noted. Moody's employs the following designations to indicate the relative repayment ability of rated issuers:

P-1 – Issuers (or supporting institutions) rated Prime-1 have a superior ability to repay short-term debt obligations.

P-2 – Issuers (or supporting institutions) rated Prime-2 have a strong ability to repay short-term debt obligations.

P-3 – Issuers (or supporting institutions) rated Prime-3 have an acceptable ability to repay short-term obligations.

APPENDIX B

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 Credit Criteria
Debt Management Office Deposit Facility	High – Govt-backed
UK Government Gilts	High – Govt-backed
Term deposits – other Local Authorities and Police, Fire and National Park Authorities	See schedule Annex A
Deposits - Money Market Funds and Government Liquidity Funds	See schedule Annex A
Call deposits (instant notice)– UK banks and building societies	See schedule Annex A
Term deposits – UK banks and building societies	See schedule Annex A

APPENDIX B

Non Specified Investments

	Minimum Credit Criteria	A. Why use it B. Associated Risks
Term deposits – other Local Authorities and Police, Fire and National Park Authorities (with maturities in excess of 1 year)	See schedule Annex A	<p>A. Certainty of rate of return over period invested. No movement in capital value of deposit despite changes in interest rate movement.</p> <p>B. Illiquid; as a general rule, cannot be traded or repaid prior to maturity. Return will be lower if interest rates rise after making the investment. Credit risk; Very low.</p>
Term deposits – UK banks and building societies (with maturities in excess of 1 year)	See schedule Annex A	<p>A. Certainty of rate of return over period invested. No movement in capital value of deposit despite changes in interest rate movement.</p> <p>B. Illiquid; as a general rule, cannot be traded or repaid prior to maturity. Return will be lower if interest rates rise after making the investment.</p>
Deposits - Money Market Funds and Government Liquidity Funds (with maturities of less than 1 year)	See schedule Annex A	<p>A. AAA rated and daily access. Diversification of assets means that risks are lower.</p> <p>B. There is a possibility of capital fluctuations due to the nature of the underlying investments but this is minimised by the structure of the fund.</p>
UK Government Gilts	See schedule Annex A	<p>A. Low risk Government backed. Liquid as they can be traded</p> <p>B. There is a possibility of capital fluctuations.</p>

APPENDIX B

ANNEX A - Treasury Management Counterparty list

Lending Criteria for Funds and Period Lent

Category	Credit Rating	Max. Funds Lent	Max. Lending Period
UK Government deposits	N/A	Unlimited	N/A
UK Government Gilts	N/A	£5m	5 years
UK Banks and Building Societies	AAA, AA plus & AA AA minus	£2.5m £2.5m	3 months 3 months
Deposits - Money Market Funds and Government Liquidity Funds	AAA	£2.5m	3 months
Local Authorities: Fire Authorities, Police Authorities National Park Authorities	N/A	£2.5m	1 year
The Council's clearing Bank – Co-operative Bank Plc	A	£5m	overnight

APPENDIX C

UK Registered Banks and Building Societies that meet the proposed minimum
Credit Rating Criteria

Bank/Building Society	Long Term Rating	Short Term Rating
Abbey Plc	AA-	F1+
AIB Group (UK) Plc	AA-	F1+
Alliance and Leicester	AA-	F1+
Bank of Scotland Plc	AA	F1+
Barclays Plc	AA	F1+
Clydesdale Bank	AA-	F1+
HSBC Bank Plc	AA	F1+
Lloyds TSB Bank	AA+	F1+
MBNA Europe Bank Ltd	AA-	F1+
Nationwide Building Society	AA-	F1+

PRUDENTIAL CODE INDICATORS

1 Capital Expenditure

- 1.1 The Chartered Institute of Public Finance and Accountancy's "Prudential Code" requires us to estimate the capital expenditure that we plan to incur over the medium term. Our capital strategy, asset management plan, ICT projects programme and service plans between them set out our capital needs.
- 1.2 The following table shows existing capital commitments together with the value of sums provisionally allocated for new investment.

Capital Expenditure				
2007/08 £000 Actual	2008/09 £000 Estimate	2009/10 £000 Estimate	2010/11 £000 Estimate	2011/12 £000 Estimate
4,559	2,000	3,000	3,000	1,500

2 Prudential indicators for affordability, prudence and sustainability

- 2.1 The Prudential Code requires that a number of indicators are calculated to demonstrate the affordability of our plans. These address the revenue implications of our financial strategy.
- 2.2 **Ratio of financing costs to net revenue stream -**
This indicator measures the ratio of financing costs, e.g. interest on investments less costs of borrowing to our net revenue stream. For us, the figure is negative as we have substantial investments that generate interest. Estimated figures are as follows:

Ratio of financing costs to net revenue stream				
2007/08 Actual	2008/09 Estimate	2009/10 Estimate	2010/11 Estimate	2011/12 Estimate
-13%	-12%	-9%	-7%	-7%

2.3 The Capital Financing Requirement –

The Capital Financing Requirement measures the amount of capital spending that has not yet been financed by capital receipts, capital grants or contributions from revenue income. It is a measure of the underlying need to borrow for a capital purpose. Our Capital Financing Requirement is minus £98,000 which means that we have this amount

available for new capital investment without having to borrow. We are debt-free and consequently have no need to borrow money for capital purposes.

- 2.4 In accordance with best professional practice, we do not associate the choice of financing with particular items or types of expenditure. We have an integrated treasury management strategy and have adopted the *CIPFA Code of Practice for Treasury Management in the Public Services*. We have at any point in time, a number of cashflows both positive and negative, and manage our treasury position in terms of our investments in accordance with our approved treasury management strategy and practices. In day to day cash management, no distinction can be made between revenue cash and capital cash. Cash requirements arise as a consequence of all the financial transactions of the authority and not simply those arising from capital spending. In contrast, the Capital Financing Requirement reflects our underlying need to finance capital investment only.
- 2.5 *CIPFA's Prudential Code for Capital Finance in Local Authorities* includes the following as a key indicator of prudence:

“In order to ensure that over the medium term net borrowing will only be for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total of the Capital Financing Requirement in the preceding year plus estimates of any additional Capital Financing Requirement for the current and next two financial years.”

- 2.6 The Head of Financial Services reports that we had no difficulty meeting this requirement in 2007/08, nor are any difficulties envisaged for the current or future years owing to our debt free status. This view takes into account current commitments, existing plans, and the proposals in this budget report.

2.7 **The effect of new capital investment on Council Tax levels –**

In considering its programme for capital investment, we are required within the Prudential Code to have regard to:

- Affordability, e.g. implications for Council Tax
- Prudence and sustainability, e.g. implications for external borrowing
- Value for money, e.g. option appraisal
- Stewardship of assets, e.g. asset management planning
- Service objectives, e.g. strategic planning for the authority
- Practicality, e.g. achievability of the forward plan

- 2.8 The cumulative full year effect of the capital investment on Council Tax is £1.02 in 2009/10, £1.88 (2010/11) and £2.40 (2011/12). These forward estimates are not fixed and do not commit the Council. They are based on the maximum limits for capital expenditure outlined above. Each year, we will review the level of capital investment taking

into account political priorities. For this reason, the actual impact on the Band D Council Tax in future years cannot be determined until the time the actual budget is set for those years.

3 Treasury Management Indicators

3.1 We have adopted the CIPFA Code of Practice for Treasury Management in the Public Services.

3.2 Borrowing -

We redeemed our external debt in January 2001 to enable us to benefit from debt-free status. This enables us to make investments on more advantageous terms, e.g. by allowing us to invest funds for more than one year.

3.3 Consequently, we have no proposals to borrow long term or incur other long term liabilities for the foreseeable future. Under section 3(1) of the Local Government Act 2003, however, we must set limits for external borrowing (temporary, contingencies) taking into account existing plans and the proposals within this report. It is recommended that these are set as detailed below:

- The operational boundary for the periods from 2009/10 – 2011/12 – £500,000
- The authorised limit for the same period – £4,500,000

NB. The authorised limit has been set to cover the worst case scenario, whereas the operational boundary is an estimate of a likely, prudent but not worst case scenario, without the additional headroom included within the authorised limit.

3.4 CIPFA's Prudential Code also requires that we report upon our actual external debt. The figure was NIL as at 31 March 2007.

3.5 Investment interest -

Interest rate risk management is a top priority. While fixed-rate investment can contribute significantly to reducing the uncertainty surrounding future interest rate scenarios, the pursuit of optimum performance may justify, or even demand, retaining a degree of flexibility through the use of variable interest rates on at least part of a treasury management portfolio. This is a best practice approach to treasury management and is to be encouraged to the extent that it is compatible with the effective management and control of risk.

3.6 It is recommended that we set an upper limit on our fixed interest rate investments for 2009/10, 2010/11 and 2011/12 of 100% of our outstanding investments.

3.7 It is further recommended that we set an upper limit on variable interest rate investments of 50% of outstanding investments.

3.8 Total principal sums invested-

In determining the length of time that sums are invested, we must consider the risk that we might be forced to realise investments early. This could have potentially disadvantageous results depending on market conditions. Consequently, the following limits are recommended on investments with maturities beyond the year end.

Limits to be placed on sums invested for longer than 364 days

Limits to be placed on investments that mature in the following financial years :	Upper Limit
2010/2011	£10m
2011/2012	£10m
2012/2013	£5m
2013/2014	£5m
2014/2015	£5m