

Report to: **Cabinet**

Date: **26 January 2010**

By: **Deputy Chief Executive and Director of Corporate Resources**

Title of report: **Treasury Management Strategy for 2010/11**

Purpose of report: **To determine the County Council's Authorised Limit for borrowing, adopt the prudential indicators and limits, to approve the Minimum Revenue Provision (MRP) Statement and to approve the treasury management strategy and policy statement for the remainder of 2009/10 and for 2010/11.**

RECOMMENDATIONS

To Cabinet is recommended to recommend the County Council to:

- (i) determine that for 2010/11 the Authorised Limit for borrowing shall be £352m.;**
 - (ii) adopt the prudential indicators as set out in the attached appendix;**
 - (iii) approve the Minimum Revenue Provision (MRP) Statement for 2010/11 as set out in the attached appendix paragraph 6;**
 - (iv) approve the treasury management strategy and policy statement for 2010/11 as set out in the attached appendix, and the new clauses of the CIPFA Code of Practice (paragraph 9 of Appendix).**
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1. Financial Appraisal

1.1 This report contains recommendations about the borrowing limits, the prudential indicators and limits, and strategy and policy changes. The proposed Strategy and Policy for the remainder of 2009/10 and 2010/11 follows previous changes, in the light of changes in the financial markets, agreed by the Cabinet in January 2009 and updated in April, July and November. The only change now recommended is to increase the option for the maximum length of new investments from 3 months to 1 year. The other recommendations are required to meet legislative requirements for setting limits and publishing prudential indicators.

1.2 The emphasis will continue to be on security (protection of the capital sum invested) and liquidity (keeping money readily available for expenditure when needed) rather than on yield. The strategy and limits are consistent with the proposed capital programme and revenue budget dealt with elsewhere on the agenda. The strategy aims to secure investment income of at least base rate plus 0.5% on the Council's general cash balances. As will be clear from the events globally and nationally over the last eighteen months, it is impossible in practical terms to eliminate all credit risk. This Council seeks to be as prudent as possible.

1.3 Whilst the Council is recommended to approve increased borrowing limits to finance the capital programme in reality, due to the current climate, no new external borrowing is being undertaken and existing cash balances are being used for "internal borrowing" to finance the programme.

2. Supporting Information

2.1 East Sussex County Council defines its treasury management activities as the management of the organisation's cash flows, its banking, money market and capital market transactions, the effective management of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

2.2 Under Section 3 (1) of the Local Government Act 2003 and the Prudential Code for Capital Finance 2004, the County Council is required to determine its authorised borrowing limit, to adopt treasury management prudential indicators and limits and to agree its treasury management strategy and policy statement.

2.3 The key driver remains the prudent approach to Treasury Management taken by this authority and an investment emphasis on security and liquidity. The aim is to receive an investment income on general balances of at least base rate plus 0.5% whilst ensuring, so far as possible in the current climate, the security of principal and the minimisation of potential risk exposure.

The list of organisations used for investment

2.4 It is necessary to continually review the list of approved organisations used and amounts able to be lent to the organisations used for investment of surpluses. In the last year, there have been no changes to the list of approved organisations used for investment of short term surpluses. The proposals for the remainder of 2009/10 and 2010/11 are unchanged as set out in the Appendix (paragraph 3.7).

Current risks and their management

2.5 The situation on the investment of surplus funds changed substantially at the beginning of 2008 and has been constantly changing since then. The original strategy for 2009/10 was set in this background of uncertainty and an extremely prudent approach was taken with nearly all investments on an overnight basis (on call) and with a limited number of high quality counterparties, particularly the Government's Debt Management Office (DMO). The changes in the strategy during the current financial year have increased flexibility by increasing the maximum limit to be lent to approved counterparties (the highest rated banks) and the period of investment increased to three months. The only change now proposed is to increase the period of investment to up to a year but this will only be after the Deputy Chief Executive and Director of Corporate Resources is satisfied that the market conditions are favourable. There is no change to the list of counterparties and the limit of the investment remains at a maximum of £60m.

Operational Boundary and Authorised Limit for borrowing

2.6 The background information and the calculation of the revised limits for 2010/11 of £332m (Operational Boundary) and £352m (Authorised Limit) are set out in the attached appendix (paragraph 4).

Prudential indicators and Treasury Management indicators

2.7 These are self-imposed indicators that are set on an annual basis (paragraph 5).

Capital Financing Requirement and Minimum Revenue Provision statement

2.8 This is set out in paragraph 6 of the appendix to comply with best practice.

Treasury management strategy and policy statement for 2010/11

2.9 The policy statement remains unchanged from the current year and is set out in paragraph 8 of the attached appendix. The revised CIPFA Code of Practice on Treasury Management introduces an additional clause to be formally adopted. All four clauses are set out for adoption in paragraph 9 of the attached Appendix. The strategy proposed for the remainder of 2009/10 and 2010/11 is as set out in paragraph 3 of the attached appendix.

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BACKGROUND DOCUMENTS

CIPFA Prudential Code in November 2009

CIPFA Treasury Management in the Public Services- Code of Practice (provisionally updated in November 2009)

Prudential Code for Capital Finance 2004

Local Government Act 2003

Local Government Investments – Guidance from the former Office of the Deputy Prime Minister.

Local Government and Public Involvement in Health Act 2007

Communities and Local Government-Changes to the Capital Finance System-Consultation 2009

Appendix to Cabinet Report - Treasury Management Strategy for 2010/11

1. Background information

1.1 Cabinet receive an annual Treasury Management Strategy report, normally in January or February, which sets out the proposed strategy for the year ahead. This strategy includes the limits and criteria for organisations to be used for the investment of cash surpluses and has to be approved by the County Council.

1.2 This Council has always adopted a prudent approach on its investment strategy and in the last few years, there have been regular changes to the list of the approved organisations used for investment of short term surpluses. This list is regularly reviewed to ensure that the Council is able to invest in the best available rates consistent with low risk; the organisations are regularly monitored to ensure that their financial strength and low risk has been maintained.

1.3 When the original strategy for 2009/10 was drawn up, the money markets were extremely volatile with Banks reluctant to lend to each other and the rates varying substantially from day to day and from Bank to Bank. In this climate ensuring the security of investments become even more difficult and extreme caution had to be taken on where surplus funds were invested.

Strategy and amendments to strategy for 2009/10 to date

1.4 The strategy for 2009/10, agreed in January 2009 was set in this background of uncertainty and an extremely prudent approach was taken with nearly all investments on an overnight basis (on call). The changes in the strategy during the current financial year have increased flexibility by increasing the maximum limit to be lent to the counterparties that the County Council already invest with (the highest rated banks) and the period of investment has been increased to three months.

1.5 The current strategy agreed by Cabinet on 26 January 2009, and updated in April, July and November 2009 and as approved by subsequent full Council meetings is:-

- In the current economic climate it is essential that a very prudent approach is maintained. This will be primarily achieved through investing for up to a period of three months with selected banks and funds which meet the Council's rating criteria.
- It is also important to recognise that movements within the money markets can happen with no notice and the Deputy Chief Executive and Director of Corporate Resources may have to amend this strategy in order to safeguard Council funds. As in the past any such actions will be reported to the next Cabinet meeting. An example of that is exercising a judgement to place more weight on UK Government's moral guarantee to high street banks if there are marginal movements in credit rating for the same high street banks.
- It is not expected that any new external borrowing will be undertaken in January 2009 to March 2010 however the limits set out in the original strategy would allow such borrowing. External borrowing will only take place if the rates available are so low that the long term benefits will significantly exceed the short term cost.
- As well as using internal borrowing to finance new capital investment it is further proposed to repay some £13m of existing PWLB loans. Further cost effective repayment opportunities will be taken if and when they emerge.
- The different elements of the total cash balances to be invested will be dealt with as follows:

Fire Authority – invested in line with own specific policy

Specific Council reserves – will not be separate for investment purposes.

Up to a maximum of £60m deposited up to a period of three months with any of the following: -

Bank / Fund
Barclays
Lloyds HBOS
Nat West/RBS
Santander (ex Abbey National)
HSBC
Nationwide
Individual Treasury Type Money Market Funds (AAA rated)
Individual Cash Type Money Market Funds (AAA rated)

Only banks which are eligible for the Government's Credit Guarantee Scheme AND meet the following minimum rating criteria for at least two of the designated agencies to be used.

Ratings Agency	Long Term	Short Term
Fitch	AA-	F1+
Moody	AA3	P-1
Standards and Poors	AA-	A-1+

The policy retains the ability to revert to some, or even extensive use of the Government's Debt Management Account Deposit Facility (DMADF) if market risk conditions tighten.

2 Formulating a Strategy for the remainder of 2009/10 and for 2010/11

Borrowing

2.1 Previously, the County Council had a strategy to borrow to support the Capital Programme and lend out other cash (rather than using internal borrowing). Historically this meant that the interest rate earned on cash balances was higher than the interest rate paid on loans from the Public Works Loans Board (PWLB). In the more recent current financial climate, this interest rate differential has been removed. No new PWLB borrowing has taken place since January 2008 and is unlikely in the current climate unless long term PWLB rates reach a very low level (where the long term benefit would exceed the short term costs). Indeed, as well as using the existing cash balances to finance capital spending (rather than new borrowing) it was also considered prudent to repay early some £13m of relatively expensive PWLB loans which was due to mature in the next 5 years. This was completed in February 2009 and has reduced the overall counterparty risk on lending, and gave some modest savings (even after paying the PWLB premium for early redemption). Further such opportunities are monitored but have not arisen yet.

Investment

2.2 It is important to take account of the current and predicted future state of the financial sector. The state of the money markets has slightly improved over the last few months. The following factors must be taken into account:

- Bank rate is currently at 0.5% (the lowest on record) and these short-term interest rates are expected to remain on hold for a considerable time. The recovery in the economy has commenced but it will remain insipid and there is a danger that early reversal of monetary ease, (rate cuts and Quantitative Easing (QE)), could trigger a dip back to negative growth. Lack of bank activity and weak consumer expenditure in response to future tax rises will also be factors that hold back growth.
- With inflation set to remain subdued in the next few years (though a sharp blip is forecast for the next few months), the pressure upon the Monetary Policy Committee to hike rates will remain moderate. But some increase will be seen as necessary in 2010 to counter the effects of external cost pressures (as commodity price strength filters through) and to avoid damage that sterling could endure if the UK is seen to defy an international move to commence policy exit strategies.

- Longer term interest rates are expected to be more volatile. There is a prediction of an increase for a number of reasons: 1) net gilt issuance will rise sharply, 2) this will be increased by the extent to which the Bank of England attempts to claw back funds injected to the economy via the QE programme; 3) investors will be looking to place more of their funds in alternative instruments as their risk appetite increases, demand for gilts will weaken as a consequence; 4) a decision to leave QE in place will generate inflation concerns and pressurise long yields higher.

The strategy going forward must continue with the policy of ensuring minimum risk but will also need to deliver secure investment income of at least bank rate on the Council's cash balances. (The actual target is bank rate plus 0.5%).

3 Proposed Strategy for the remainder of 2009/10 and for 2010/11

3.1 In the current economic climate it is essential that a prudent approach is maintained. This will be achieved through investing with selected banks and funds which meet the Council's rating criteria. The emphasis will continue to be on security (protection of the capital sum invested) and liquidity (keeping money readily available for expenditure when needed) rather than on yield. The proposed strategy continues with this prudent approach and the only change proposed is to increase the period of investment to up to a year but this will only be after the Deputy Chief Executive and Director of Corporate Resources is satisfied that the market conditions are favourable. There is no change to the list of counterparties or the limit of the investment remains at a maximum of £60m.

3.2 It is also important to recognise that movements within the money markets can happen with no notice and the Deputy Chief Executive and Director of Corporate Resources may have to amend this strategy in order to safeguard Council funds. As in the past any such actions will be reported to the next Cabinet meeting.

3.3 It is not expected that any new external borrowing will be undertaken in the next 15 months however the limits set out in paragraph 4 would allow such borrowing. External borrowing will only take place if the rates available are so low that the long term benefits will significantly exceed the short term cost.

3.4 Opportunities for cost effective repayment of existing debt and restructuring opportunities are constantly monitored and will be taken if and when they emerge.

3.5 Our policy gives some flexibility to borrow up to £23m in advance of future need. The detail is set out in paragraphs 4.2 and in the table at 5.2. However, given the current interest climate, no external borrowing and certainly none in advance, is planned.

3.6 The funds of the Fire Authority will continue to be invested in line with their own specific policy.

3.7 The County Council funds will be invested

Up to a maximum of £60m deposited up to a period of up to one year with any of the following: -

Bank / Fund
Barclays
Lloyds HBOS
Nat West/RBS
Santander (ex Abbey National)
HSBC
Nationwide
Individual Treasury Type Money Market Funds (AAA rated)
Individual Cash Type Money Market Funds (AAA rated)

Only banks which are eligible for the Government's Credit Guarantee Scheme AND meet the following minimum rating criteria for at least two of the designated agencies to be used.

Ratings Agency	Long Term	Short Term
Fitch	AA-	F1+
Moody	AA3	P-1
Standards and Poors	AA-	A-1+

The policy retains the ability to revert to some, or even extensive use of the Government's Debt Management Account Deposit Facility (DMADF) if market risk conditions tighten.

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

3.9 All of the investments will be classified as Specified Investments. These investments are sterling investments of not more than one-year maturity with institutions we deem to be high credit quality or with the UK Government (Debt Management Account Deposit Facility). These are considered low risk assets where the possibility of loss of principal or investment income is small. The County Council does not have any Non Specified Investments which are ones of more than one-year maturity or with institutions which have a lesser credit quality.

4 Authorised Limit for borrowing in 2010/11

4.1 The Government introduced a new system for capital finance from 1st April 2004. An objective of this new system was to move away from controlling borrowing through the issue of borrowing approvals, towards a system of self-regulation. This is based on a code of practice developed by CIPFA- the Prudential Code.

The Authorised Limit for borrowing determined for 2010/11 will be the statutory limit determined under section 3(1) of the Local Government Act 2003.

4.2 The Prudential Code for Capital Finance allows capital borrowing to be planned over the same timescale as capital spending. The code states:

"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 capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years".

The limits set out later in this report have been based upon the amount of capital spending to be financed through borrowing in 2010/11 and following financial year. Whilst the Prudential Code would allow a higher limit than this (2010/11 and next two financial years) it is considered prudent at this stage to base the limits upon 2 years. This approach was agreed by the County Council in July 2004 and has worked well.

4.3 For 2010/11 it is estimated that the Authorised Limit for borrowing is £352m (see table 5.2) should be determined as usual although, as stated earlier, additional external borrowing is not expected to be undertaken.

5 Prudential indicators and Treasury Management indicators

5.1 There are self-imposed prudential and treasury management indicators that are set on an annual basis. The indicators which relate to treasury management are included below:

- Operational Boundary and Authorised Borrowing Limit (which also include short term borrowing) (see paragraphs 5.2 and 5.3 below)
- Interest rate exposures (see paragraph 5.4 below)
- Maturity structure of debt (see paragraph 5.5 below)
- Compliance with the treasury management code of practice (see paragraph 5.6 below)
- Maturity structure of investments (see paragraph 5.7 below)

Operational Boundary and Authorised Limit for Borrowing

5.2		Actual 2008/09	Near Actual 2009/10	Estimate 2010/11	Estimate 2011/12	Estimate 2012/13
		£m	£m	£m	£m	£m
	Opening Balance	274	284	295	309	322
	New borrowing for capital programme	21	22	26	25	21
	Less repayment of debt	-11	-11	-12	-12	-13
A	* Closing balance (no borrowing in advance)	284	295	309	322	330
B	Advance borrowing allowed (£10m plus net borrowing for following year)	21	21	23	18	17
A+B	Operational Boundary	305	316	332	340	347
C	Short Term (£20m)	20	20	20	20	20
A+B+C	Authorised Limit	325	336	352	360	367
D	* Borrowing to date	264	264			
D-A	* Remainder of planned borrowing	20	31			

* The balance (at A) represents the Council's Capital Financing Requirement (CFR) and with no under or over external borrowing it would equal the Council's external capital debt. Actual external debt (D) is lower as no external borrowing has taken place since 2007/08 (see also paragraph 6.1).

The proposed Operational Boundary for borrowing is based on the same estimates as the Authorised Limit but without the additional amount for short term borrowing included to allow, for example, for unusual cash movements. The Operational Boundary represents a key management tool for in year monitoring and long term borrowing control.

5.3 The Authorised Limit is consistent with the Council's current commitments, existing plans and the proposals for capital expenditure and financing, and with its approved treasury management policy statement and practices. They are based on the estimate of the prudent but not worst case scenario plus sufficient headroom (short term borrowing) over and above this to allow for day to day operational management, for example unusual cash movements or late receipt of income.

Interest rate exposure

5.4 The Council will continue the current practice of seeking to secure competitive fixed interest rate exposure. It is proposed to continue to set limits which would allow variable rate borrowing and lending in case that becomes a more effective approach. The table below shows both borrowing and lending and a combined borrowing and lending table.

<u>Borrowing</u>	2009/10 Projected <u>Outturn</u>	2010/11 <u>Estimate</u>	2011/12 <u>Estimate</u>	2012/13 <u>Estimate</u>
Fixed Rate Exposure				
Upper Limit	100%	100%	100%	100%
Lower Limit *	70%	55%	54%	53%
Variable Rate Exposure				
Upper Limit	30%	45%	46%	47%
Lower Limit *	0%	0%	0%	0%

(* assumes all new borrowing is variable)

Lending

Fixed Rate Exposure				
Upper Limit	100%	100%	100%	100%
Lower Limit	0%	0%	0%	0%
Variable Rate Exposure				
Upper Limit	100%	100%	100%	100%
Lower Limit	0%	0%	0%	0%

Borrowing and Lending combined

Fixed Rate Exposure				
Upper Limit	100%	100%	100%	100%
Lower Limit	32%	28%	27%	26%
Variable Rate Exposure				
Upper Limit	100%	100%	100%	100%
Lower Limit	0%	0%	0%	0%

Maturity structure of debt

5.5 The Council has set upper and lower limits for the maturity structure of its borrowings as follows.

	<u>Lower limit</u>	<u>Upper limit</u>	<u>Current</u>
Under 12 months	0%	25%	0%
12 months and within 24 months	0%	40%	0%
24 months and within 5 years	0%	60%	2%
5 years and within 10 years	0%	80%	8%
10 years and within 20 years	0%	80%	18%
20 years and within 30 years	0%	80%	18%
30 years and within 40 years	0%	80%	22%
More than 40 years	0%	80%	32%

Compliance with the treasury management code of practice

5.6 East Sussex County Council has adopted the *CIPFA Code of Practice for Treasury Management in the Public Services* but the revised *CIPFA Code* requires an additional clause to be adopted for full compliance. This is shown as paragraph 9 of the Appendix.

Maturity structure of investments – Investment of surpluses for a period of more than one year and up to five years.

5.7 Investments will be made in line with the strategy and does not allow investments beyond one year.

6 Capital Financing Requirement and Minimum Revenue Provision (MRP) Statement

The Council's Borrowing Need (the Capital Financing Requirement)

6.1 The prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of Council's underlying borrowing need.

6.2 The Council is asked to approve the CFR projections below:

£m	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
Total CFR	295	309	322	330
Movement in CFR	11	14	13	8

Movement in CFR represented by				
Net financing need for the year (above)	22	26	25	21
MRP/VRP and other financing movements	-11	-12	-12	-13
Movement in CFR	11	14	13	8

The Council is required to pay off an element of the accumulated General Fund capital spend each year through a revenue charge (the Minimum Revenue Provision – MRP).

6.4 CLG Regulations have been issued which require full Council to approve an MRP Statement in advance of each year. A variety of options are provided to councils to replace the existing Regulations, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement.

6.5 For capital expenditure incurred before 1 April 2008 or which in the future will Supported Capital Expenditure, the MRP policy will be:

- Based on based on the non-housing CFR, i.e., The Council currently set aside a Minimum Repayment Provision based on basic MRP of 4% each year to pay for past capital expenditure and to reduce its CFR.

6.6 From 1 April 2008 for all unsupported borrowing the MRP policy will be:

- Asset Life Method – MRP will be based on the estimated life of the assets, in accordance with the proposed regulations (this option will be applied for any expenditure capitalised under a Capitalisation Direction).
- Asset Life Method (annuity method) The Council will also be adopting the annuity method, - MRP calculated according to the flow of benefits from the asset, and where the principal repayments increase over the life of the asset. The policy is being adopted as a result of any PFI's assets coming on the balance sheet and any related MRP will be equal to the amount of principal repayment.

7. Treasury Management Advisers

The Council uses Butlers as its treasury management consultant. The company provides a range of services which include:

- Technical support on treasury matters, capital finance issues and advice on reporting;
- Economic and interest rate analysis;
- Debt services which includes advice on the timing of borrowing;
- Debt rescheduling advice surrounding the existing portfolio;
- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings from the three main credit rating agencies and other market information;
- Assistance with training on treasury matters

Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remains with the Council. This service is subject to regular review.

8 Treasury Management Policy Statement for 2010/11

It is recommended that the Treasury Management Policy Statement for 2010/11 should be unchanged. The Statement is set out below

East Sussex County Council defines its treasury management activities as:

“The management of the organisation’s cash flows, its banking, money market and capital market transactions, the effective management of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.”

The County Council regards the successful identification, monitoring and management of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.

This authority acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

9 Clauses to be formally adopted as part of the CIPFA Treasury Management Code of Practice

Our existing approach already covers these areas (with the exception of a formal mid year review report) but Cabinet is now recommended to formally adopt them:-

1. East Sussex CC will create and maintain, as the cornerstones for effective treasury management:
 - A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities;
 - Suitable Treasury Management Practices (TMPs) setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.
2. The Council will receive reports on its treasury management policies, practices and activities, including as a minimum, an annual strategy and plan in advance of the year, a mid year review and an annual report after its close, in the form prescribed in its TMPs.
3. East Sussex CC delegates responsibility for the implementation and monitoring of its treasury management policies and practices to the Cabinet, and for the execution and administration of treasury management decisions to the Deputy Chief Executive and Director of Corporate Resources, who will act in accordance with the Council's policy statement and TMPs and CIPFA's Standard of Professional Practice on Treasury Management.
4. The County Council nominates the Audit and Best Value Scrutiny Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.