MAIDSTONE BOROUGH COUNCIL

RECORD OF DECISION OF THE CABINET

Decision Made: 09 February 2011

TREASURY MANAGEMENT STRATEGY 2011/12

Issue for Decision

Review Treasury Management for 2010/11 and consider future Treasury Management Strategy for 2011/12. This will include Prudential Borrowing limits and a proposed Approved Investment Strategy. These matters will be submitted to Council.

Decision Made

1. That delegated authority be given to the Director of Regeneration and Communities to refine the Prudential Indicators, should the need arise following the decision of the Cabinet on the Budget Strategy 2011/12, before Council on 2 March 2011.

2. That the draft Treasury Management Strategy for 2011/12 be recommended to Council.

Reasons for Decision

The council has adopted CIPFA's Code of Practice on Treasury Management and this requires that the Council sets out a treasury management strategy on an annual basis. This recommendation considers that strategy for 2011/12 onwards along with current guidance from CIPFA and the CLG.

The primary requirements of the Code are as follows:

a) Receipt by full Council of an annual Treasury Management Strategy – including the Annual Investment strategy and Minimum Revenue Provision Policy – for the year ahead.

b) Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

c) Delegation by the Council of the role of scrutiny of treasury management strategy and policies, a Mid Year Review Report and an Annual Report covering activities during the previous year to Audit Committee.

The process for approval is:

a) Audit Committee will consider the initial draft and make recommendations to Cabinet.

b) Cabinet will consider and recommend to Council

c) Council will approve the strategy each March for the forthcoming financial year.

2010/11 Strategy

The current strategy agreed by Council in February 2010 had recommended the following:-

a) Keep investments short term (up to 1 year) to help fund the existing capital programme when needed and to make funds available to invest if rates increased;

b) Amend the counterparty list to show top 10 Building Societies rather than top 30;

c) No planned borrowing, other than for short-term cashflow purposes. The council is currently debt-free;

d) That the Head of Finance & Customer Services be given delegated authority (in consultation with the Cabinet Member for Corporate Services) to make use of alternative investment instruments should it be considered prudent to do so and should it be of advantage to the council;

e) That the council's Treasury Management Practices are amended to reflect these decisions.

Current Cashflow Performance

At the November Cabinet meeting the second quarter monitoring report included details of the mid year performance for 2010/11 including the position as at 30th September 2010. Listed below is an update on that position.

The Council's investment position during this financial year and the expected position at the year end is as follows:

	£m
Investments as at 1st April 2010	8.7
Investment Balance as at 9th Dec 2010	32.3
Investment Income as at 9th Dec 2010	0.23
Ave Balance/Rate of Investments during year	23.0
Est. Investments as at 31st March 2011	18.0

In 2010/11 to date, the average level of investments are higher than anticipated due to the following reasons:

Lower NNDR Contribution requirement	£5.0m
HB Subsidy 2009/10 Adj.	£2.0m
VAT Fleming Interest	£1.1m
Other	£0.5m
Total	**£8.6m**

The level of investments at 1st April 2010 was £8.7m and has varied during the year as a result of day to day cashflow management. It is anticipated the level of investments at 31st March 2011 will be £18m mainly due to capital slippage, revenue under spends, and the issues listed above.

Despite the increased level of investments, the interest rates have remained unchanged. It was originally forecast that rates would move up from early 2010 and continue rising throughout the year. The level of investment income for 2010/11 is expected to be £35k below the estimate of £405k. This variance has been reported to Cabinet and management action will ensure the budget pressure is resolved.

There has been no need to borrow to date and it is anticipated that this will remain unchanged to the end of the year.

Updated Cashflow Projection

A cashflow projection up to March 2014 has been created reflecting the spending proposals in the Budget Strategy 2011/12 onwards. The cashflow projection shows that anticipated investment income will be £0.3m in 2011/12, £0.6m in 2012/13 and £0.9m in 2013/14. This is based on the selling of Council fixed assets and interest rates increasing, as forecast.

Based on the current cashflow projection the Council has anticipated cash balances at 1st April 2011 available for investment totalling £18m.

Base Rate Forecast

It is the view of the Council's Treasury Management Advisors that the first base rate increase is expected to be in the quarter ending December 2011 and it will continue to rise steadily thereafter. A table of Sector's prediction on base rate is below.

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
Bank rate	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.25%	2.75%	3.00%	3.25%	3.25%

Economic Background

Following the general election in May 2010, the coalition government has put in place a plan to reduce the public sector deficit over the next five years. The risks arising from the government's plans include possible job losses, reduced consumer & business confidence and a negative effect on the housing market. These risks must be considered during the development of any future strategies. This will have a knock on effect on consumer and business confidence and appears to have also hit the housing market as house prices started on a negative trend during the summer and autumn of 2010. Mortgage approvals are also at very weak levels and declining, all of which indicates that the housing market is likely to be very weak next year.

The Council's Treasury Management Advisors have provided the following assessment of the current and near likely situation:-

a) CPI has remained high during 2010. It peaked at 3.7% in April and has gradually declined to 3.1% in September (RPI 4.6%), but has started to increase again to 3.3% in November (RPI 4.7%). Although inflation has remained above the Monetary Policy Committee's (MPC's) 2% target, the MPC is confident that inflation will fall back under the target over the next two years after another rise back up to about 3.5% by the end of 2010.

b) There is some risk of a double dip recession, creating a downward spiral of falling demand, falling jobs and falling prices, although this is currently viewed as being a small risk.

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

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

<u>Evaluation of 2011/12</u>

In formulating and executing the strategy for 2011/12, the Council will have regard to the CLG's guidance on Local Government Investments and the 2009 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectional Guidance Notes.

CIPFA's Treasury Management Code of Practice states that "in balancing risk against return, local authorities should be more concerned to avoid risks rather than maximising return". Therefore the underlying principles of the strategy are to ensure absolute security of Council funds, and to minimise large variations in annual investment returns, which would impact upon the budget.

The Council will also achieve optimum return on its investments commensurate with proper levels of security and liquidity. The borrowing of monies purely to on lend and make a return is unlawful and the Council will not engage in such activity.

Investment instruments identified for potential use in the financial year are listed at Appendix B of the report of the Head of Finance and Customer Services under the 'Specified' and 'Non-Specified' investments categories, as per CLG's guidance. Specified instruments are those investments which are sterling denominated, with maturities up to a maximum of 1 year, meeting the minimum high rating criteria. Non-specified investments are included at the Council's discretion, based on guidance from our Treasury Management Advisors.

The Council, in conjunction with its Treasury Advisor, Sector, will use Fitch, Moodys and Standard and Poors ratings in combination to derive its credit criteria. All credit ratings will be monitored daily. The Council is alerted to changes in ratings of all agencies through its use of the Sector creditworthiness service.

If a downgrade means the counterparty or investment scheme no longer meets the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

If a body is placed under negative rating watch (i.e. there is a probability of a rating change in the short term and the likelihood of that change being negative) and it is currently at the minimum acceptable rating for placing investments, then no further investments will be made with that body.

In addition to the use of Credit Ratings the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in a downgrade of an institution or removal from the Council's lending list.

Other market intelligence will also be used to determine institutions credit worthiness, such as financial press, financial broker advice and treasury management meetings with other authorities, e.g. Kent Treasury Management Forum. If this information shows a negative outcome, no further investments will be made with that body.

At this stage it is anticipated that the current approved forms of investment will be sufficient to deliver the strategy based on current and forecast base rate projections. However, actual base rates can deviate significantly from those forecast, so it would be appropriate to have a flexible approach to the use of the alternative instruments listed in Appendix B to the report of the Head of Finance and Customer Services.

The Head of Finance & Customer Services has previously been given delegated authority to use alternative forms of investment, should the appropriate opportunity arise to use them, and should it be prudent and of advantage to the Council to do so. This delegated authority is subject to prior consultation with the Cabinet Member for Corporate Services on any possible use of these instruments. This delegation has not been exercised to date.

The following table shows the balance of investments which will mature during 2011/12 and the total of this balance which will be needed to fund the revenue/capital expenditure.

Investment	2011/12 £m
Short Term Investments at start of Year	18.0
Use of Balances/Capital receipts	12.9
Available for Investment	**5.1**

These maturities will therefore cover the anticipated use of cash balances for the period and leave £5.1m available for investment, along with day to day cashflow management funds.

As mentioned previously interest rates are projected to rise during 2011 and continue this trend through to December 2013. The budget for investment income is based on this projection. The table below compares the current market rates to the base rate over the same period:

Rates based on investment of £1m	Market Rate	Forecast base rate
1 Month deposit (Jan 11)	0.60%	0.50%
3 Month Deposit (May 11)	0.90%	0.50%
6 Month Deposit (Aug 11)	1.25%	0.50%
9 Month Deposit (Nov 11)	1.50%	0.50%
1 Year Deposit (Dec 11)	1.85%	0.75%
2 Year Deposit (Dec 12)	2.00%	1.75%
3 Year Deposit (Dec 13)	2.45%	3.25%

This table shows investments up to 2 years offer good value, with the best rates being between 6 and 9 months. After 2 years, with the increases in base rate, they are less promising. It has been suggested by the Council's Treasury Management advisors to keep investment short term (less than 1 year), but maybe use core cash for up to 1 year if rates are at a premium.

The current strategy for 2011/12 onwards shows there is no need to borrow but depending on sale of Council assets, the current capital programme would need an additional £2.4m of funding by 2012/13. Within the code CIPFA suggest that local authorities are able to borrow ahead of need. This should only occur where the need is identified within the current capital programme and medium term financial strategy. It should also only occur where the carrying costs of the borrowing, up to the time of need to borrow, can be mitigated during the life of the loan and the security of these funds has to be documented prior to borrowing being undertaken.

A profile of the forecasted PWLB rates against Base rate are as follows:

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
Bank rate	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.25%	2.75%	3.00%	3.25%	3.25%
5yr PWLB rate	3.00%	3.00%	3.10%	3.20%	3.30%	3.50%	3.80%	4.10%	4.30%	4.40%	4.50%	4.70%	4.90%	5.00%
10yr PWLB rate	4.10%	4.10%	4.10%	4.20%	4.30%	4.40%	4.60%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%	5.40%
25yr PWLB rate	5.00%	5.10%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.50%	5.60%	5.70%	5.70%
50yr PWLB rate	5.10%	5.20%	5.30%	5.40%	5.40%	5.50%	5.50%	5.50%	5.60%	5.60%	5.60%	5.60%	5.70%	5.70%

Strategy for 2011/12

Based on the issues outlined in this section and following consultation with the Council's Treasury Management advisors the following strategy is recommended:

The counterparty list - Appendix A to the report of the Head of Finance and Customer Services

a) To remain unchanged from the list agreed within the Treasury Management Strategy 2010/11. This includes the top 10 asset sized building societies, along with Kent Reliance, currently rated 11.

b) Use the Council's Treasury Management Consultant's scheme for rating of institutions for creditworthiness which uses a sophisticated modeling approach with credit rating agencies, Moodys, Fitch and Standard & Poors, along with Sovereign ratings, CDS spreads and credit watches.

c) Group limits placed on institutions within the same group and not separate for each institution. This is an added security measure as there is a burden upon the parent company. The group limit will be the highest individual credit criteria for the group.

d) An institution will never have a higher credit rating than the sovereign country it operates within. If the sovereign is downgraded below the rating of an institution, the institution is downgraded to the same level.

e) The Head of Finance & Customer Services be given delegated responsibility to add or withdraw institutions from the counterparty list when ratings change, either as advised by Sector or from another reliable market source.

Focus on Treasury Management Activity in 2011/12

a) Invest funds short term (up to one year) so that funds are available to invest when rates increase.

b) Use up to £3m from core cash balances to be invested for 1 year or above if rates are at a premium over predicted base rates and funds are available for the term.

c) There doesn't appear to be a need for borrowing within 2011/12, however should it be necessary, internal borrowing should be used to fund the capital programme, as this is the cheapest form of finance, after foregoing the low interest earned on investments. This also reduces counterparty and interest rate risk as funds would not need to be placed in the market.

Treasury Indicators

The Indicators important to the Treasury Management strategy are detailed on the attached Appendix C to the report of the Head of Finance and Customer Services, the most important of which are listed below. The upper and lower limits are set with reference to the peaks and flows of cashflow throughout the year. There always exists the possibility of the limits being approached at the start and end of each financial year when the income stream is at its lowest:

a) Authorised Limit for External Debt

This places an upper limit on the Authority's borrowing by indicating a level of debt that the authority calculates is affordable and relevant. Along with the debt held for the financing of capital expenditure and other long term liabilities, this limit includes provision for day to day cash flow needs. Borrowing above this limit should not occur.

b) Operational Boundary for External Debt

This provides a limit for day to day cash flow management. It is the equivalent of the Authorised Limit for External Debt without the allowance for cash flow purposes. It is intended that Treasury Management on a day to day basis should use this limit as a focus. Borrowing to exceed this limit should only occur for short periods of time for cash flow management purposes.

c) Actual Debt

The closing balance of actual gross borrowing plus other long term liabilities. This considers a single point in time and is only directly comparable to the authorised limit and operational boundary at that point in time.

d) Upper Limit for Fixed Rate Exposure

This places a limit on the proportion of borrowing and investment that can be at a fixed rate of interest. Due to the nature of the Council's cashflows it is likely that this limit will only be approached at the start and the end of the financial year when there are less surplus funds available for surplus investment. (Fixed rate is defined as any borrowing or investments where the rate is fixed but only where the period is in excess of one year.)

e) Upper Limit for Variable Rate Exposure

This places a limit on the proportion of borrowing and investment that can be at a variable rate of interest. The limit set reflects the fact that during the year there can be excess surplus funds available for short term investment. These arise from timing differences between receipts received and payments made. (Variable rate is defined as any borrowing or investments for a period up to a maximum of 364 days, irrespective of whether the rate is fixed or not.)

f) Upper Limit for Total Principal Sums Invested over 364 days

This limit has been set in consultation with the Council's Treasury Management Advisors, and the background to this is dealt with in more detail in the proposed investment strategy earlier in this recommendation.

g) Maturity Structure of New Fixed Rate Borrowing during 2011/12

This indicates the assumed maturity structure for any borrowing that may occur at a fixed rate of interest, during 2011/12. As any borrowing is expected to be for cash flow purposes only it will be short term borrowing at variable rates.

Alternatives considered and why rejected

The Council is required to endorse a Treasury Management Strategy and monitor and update the strategy and Prudential Indicators as necessary. The Council could endorse a simple strategy for Treasury Management. However this would be contrary to best advice from the Council's advisors and likely to produce a reduced income stream from investments.

External Fund Managers – by appointing external managers local authorities benefit from security of investments, diversification of investment instruments, liquidity management and the potential of enhanced returns and capital appreciation. Managers do operate within the parameters set by local authorities but this involves varying degrees of risk. This option has been discounted on the basis of the risk to capital receipts which would make it difficult to ascertain a suitable sum to assign to an external manager.

Background Papers

Working papers held in the Corporate Finance office.

Should you be concerned about this decision and wish to call it in, please submit a call in form signed by any two Non-Executive Members to the Head of Change and Scrutiny by: **18 February 2011**