

**MAIDSTONE BOROUGH COUNCIL**  
**RECORD OF DECISION OF THE CABINET**

Decision Made: 10 February 2010

**Treasury Management Strategy 2010/11 - 2012/13**

**Issue for Decision**

To consider and endorse, in accordance with CIPFA's Code of Practice on Treasury Management 2009 (Revised), the adoption of the Code and, in line with the code's advice, endorse the adoption a Treasury Management Strategy for 2010/11 including a series of Treasury and Prudential Indicators.

**Decision Made**

1. That the Revised Code of Practice be adopted.
2. That the proposed Treasury Management Strategy for 2010/11 be agreed.
3. That the Prudential and Treasury Indicators, as detailed in Appendix C to the Report of the Head of Finance, be agreed as amended, if necessary, by the Budget Strategy Report
4. That the Head of Finance 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;
5. That the Council's Treasury Management Practices be amended to reflect the decisions made above.
6. That the scrutiny of the proposed strategy be agreed, and the performance in year be a function of Audit Committee and that a report on this strategy and on the use of the example clauses to change the Council's financial procedure rules be presented to the Audit Committee.

**Reasons for Decision**

The Council has in the past adopted CIPFA's code of practice on treasury management and this requires that the Council sets a treasury management strategy on an annual basis. This report considers that

strategy for 2010/11 onwards along with current guidance from CIPFA and the DCLG.

CIPFA has recently published revised guidance "Treasury Management in the Public Services – Code of Practice" (the code). This revised code is a consequence of the Icelandic situation in 2008. The code supports previous codes, recommending a number of additional areas of practice required of an organisation that adopts the code. In many cases these practices form part of the Council's current activity however some require adoption by the Council to ensure full compliance with the code. These additional areas of practice are listed below, where necessary proposals for adoption are either included in the recommended strategy detailed in section 1.10 or identified in this section:

- a) Along with the formal adoption of the code, CIPFA requires Council's to include four clauses into their financial regulations. CIPFA's example clauses are given at Appendix A to the Report of the Head of Finance and although adoption would be recommended the clauses should be adjusted for the Council's circumstances and Cabinet could request that Audit Committee review the example clauses before adoption.
- b) The strategy report (i.e. this report) must affirm that the effective management and control of risk are prime objectives of the Council's treasury management activities. In addition the Council's appetite for risk must be clearly identified within the strategy with priority being given to security of capital and liquidity when investing funds and explain how that will be carried out.
- c) Credit ratings should only be used as a starting point when considering risk. Use should also be made of market data and information, the quality financial press, information on government support for banks and the credit ratings of that government support. In addition CIPFA recommend that Council's need a sound diversification policy with high credit quality counterparties and should consider setting country, sector and group limits. All of these issues are functions of the Council's relationship with its treasury management advisors who have developed analytical and reporting processes to ensure the Council is provided with this information immediately it is available.
- d) Borrowing in advance of need is only to be permissible when there is a clear business case for doing so and only for the current capital programme or to finance debt maturities.
- e) The main annual treasury management reports must be approved by full council. These are to include, at a minimum, a mid-year review of treasury management strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved and is in addition to the annual reports produced at present. This will be added to the list of reports currently produced.

- f) Each council must delegate the role of scrutiny of treasury management strategy and policies to a specific named body, in addition treasury management performance and policy setting should also be subjected to prior scrutiny. The most suitable body to be specified for such a scrutiny role is the Audit Committee.
- g) The code recommends that Members should be provided with access to relevant training. Those charged with governance are also personally responsible for ensuring they have the necessary skills and training. Responsibility for these activities must be clearly defined within the organisation. Treasury Management training has already been requested by the Audit Committee and is a regular element of updating staff involved in the day to day activity of treasury management.
- h) Officers involved in treasury management must be explicitly required to follow treasury management policies and procedures when making investment and borrowing decisions on behalf of the Council.

CIPFA has also issued a revised Prudential Code which primarily covers borrowing and the Prudential Indicators. Three of these indicators have now been moved from being Prudential Indicators to being Treasury Indicators:-

- Authorised limit for external debt;
- Operational boundary for external debt;
- Actual external debt.

However, all indicators are to be presented together as one suite. In addition, where there is a significant difference between the net and the gross borrowing position, the risks and benefits associated with this strategy should be clearly stated in the annual strategy. The indicators for 2010/11 to 2012/13 are considered above.

The code enables the Council to borrow or invest for any purpose relevant to its functions, under any enactment, or for the purpose of the prudent management of its financial affairs. It also identifies the following key principles that reflect similar issues to those outlined earlier:-

- a) Public service organisations should put in place formal and comprehensive objectives, policies and practices, strategies and reporting arrangements for the effective management and control of their treasury management activities. These are being put in place for 2010/11 by this report.
- b) Their policies and practices should make clear that the effective management and control of risks are prime objectives of their treasury management activities and that responsibility for these lies clearly within their organisations. Their appetite for risk should form part of their annual strategy and should ensure that priority is given to security and liquidity when investing funds.
- c) They should acknowledge that the pursuit of value for money in treasury management and the use of suitable performance measures

are valid and important tools for responsible organisations to employ in support of their business and service objectives; and that within the context of effective risk management, their treasury management policies and practices should reflect this.

It is a statutory requirement under Section 33 of the Local Government Finance Act 1992 for the Council to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This therefore means that increases in capital expenditure must be limited to a level whereby increased revenue charges from any new capital projects are restricted to a cost that is affordable within the projected income of the Council for the foreseeable future.

The Treasury Management Strategy and the Prudential and Treasury Indicators are based upon the ongoing use of the capital receipts from the stock transfer in February 2004 and other accumulated receipts, as previously agreed by Cabinet, and also proposals in the Corporate Revenue and Capital Budgets 2010/11 onwards reported elsewhere on this agenda.

#### 2009/10 Strategy

The current strategy agreed by Council in February 2009 was to invest funds short term (less than 1 year), so that funds are available to invest when rates increase.

Potential borrowing was agreed, if needed, from either external sources or using internal balances and balance sheet resources of up to £4m.

The counterparty list was updated to include nationalised banks and guaranteed deposits, as credit ratings had reduced significantly on every institution. These nationalised banks are backed by Government so it was agreed that the Sovereignty ratings would apply as the lending criteria. Banks that have received Government support were also included but to minimise the risk, the lending criteria used for non rated institutions was applied to these.

#### Current Cashflow Performance

Detailed below is the Council's current portfolio position at 15<sup>th</sup> January 2010.

	<b>Principal £m</b>	<b>Average Rate %</b>
Total Debt	0.0	
Short-term Investments	22	81

Long-term Investments	5	19
<b>Total Investments</b>	<b>27</b>	

In 2009/10, to date, the level of investments had an average balance of £24.6m. This covers investment of balances, capital receipts and other balance sheet assets. This balance is higher than anticipated as a consequence of slippage in both revenue and capital expenditure, as reported to Cabinet in various budget monitoring reports. As a consequence, in November 2009 Cabinet approved an increase in the estimate for interest receivable.

The level of investments at 1<sup>st</sup> April 2009 was £19.3m and has varied during the year as a result of day to day cashflow management. In addition, due to the impact of the economic downturn, the level of anticipated capital receipts has not been achieved although this has been offset by slippage in the level of expenditure on the capital programme. In overall terms, the level of investment at March 2009 is projected to reduce to approx £7.7m.

The slightly higher than expected levels of investments will generate income in 2009/10 of approximately £0.77m, compared to an original estimate of £0.72m.

The only borrowing that has taken place so far during 2009/10 has been for short-term cashflow purposes.

#### Updated Cashflow Projection

A cashflow projection up to March 2013 has been created reflecting spending proposals in the Budget Strategy as reported elsewhere on this agenda. The cashflow projection shows that anticipated investment income will be £0.3m in 2011/12 and £0.3m in 2012/13, based on all known factors at this point in time. The reduction over the 2010/11 estimate relates to the previously identified issues around funding of the capital programme. Investment returns will be fairly stable, even as interest rates increase due to the counteracting impact of reducing balances. The impact of reduced investment income has been a material factor in the Budget Strategy for 2010/11 and future years.

Based on the current cashflow projection the Council has anticipated cash balances at 1<sup>st</sup> April 2010 available for investment totaling £7.7m. This comprises mainly of balances and capital receipts. Based on current forecasts it is anticipated that this will be utilised or available for potential problems as follows:-

<b>Use in 2010/11</b>	<b>£m</b>
Capital Receipts	2.2
Capital Grants	1.9
Balances	0.6
<b>Total</b>	<b>4.7</b>

<b>Ongoing after 2010/11</b>	
Balances	3.0
<b>Total</b>	<b>3.0</b>

### 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 September 2010 and is expected to reach 4.5% by the end of March 2013. There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected or the Bank of England is obliged to react to excessive rises in inflation.

	<b>Mar 10</b>	<b>Jun 10</b>	<b>Sep 10</b>	<b>Dec 10</b>	<b>Mar 11</b>	<b>Jun 11</b>	<b>Sep 11</b>	<b>Dec 11</b>	<b>Mar 12</b>	<b>Jun 12</b>	<b>Sep 12</b>	<b>Dec 12</b>	<b>Mar 13</b>
<b>Bank Rate %</b>	0.50	0.50	0.75	1.00	1.50	2.25	2.75	3.25	3.50	3.75	4.25	4.25	4.50

### Economic Background

The current economic difficulties commenced around August 2007 with the major effect on the banking system being seen around September 2008. The consequence of this was that most major economies in the world were in recession by 2009. Bank base rates across the world varied from 0.10% - 1.00% in order to counter the recession.

In general, inflation has fallen in most major economies and is seen as a low risk issue for at least the next two years due to the large output gaps and high unemployment. In the UK the Government has utilised a number of fiscal stimuli to encourage the economy to move out of recession.

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

- a) GDP growth will almost get back to the long term average of about 2.5% in 2011 but is likely to peak in the first half of the year as inventory rebuilding and stimulus measures fade and fiscal contraction kicks in later in the year.
- b) Sterling has depreciated by 25% since the peak in 2007 and is likely to stay weak.
- c) Consumer spending – only a mediocre recovery is expected due to a steady increase in the savings ratio from 5.6% in 2009 to about 8% in 2011 as consumers pay down debt or build cash balances. Consumer incomes will be held down by wage freezes and increases in taxation.
- d) House price recovery is expected to persist helped by a low

Bank Rate for a prolonged period; the peak to trough fall in house prices is now expected to be no more than 20%. House prices to rise by about 6% in 2010, and 3% in 2011; mortgage approvals will rise back to the level of 75,000-80,000 per month needed to ensure a continuation of a trend of rising house prices.

- e) CPI inflation will peak at 2.5% in early 2010 after the rise in VAT in January 2010 but then fall to a trough near 1.5% in early 2011 and stay below 2% for the rest of 2011.
- f) The current MPC attitude is one of hang on as long as possible before increasing Bank Rate. The aim of this would be to try to ensure that growth gets going at a decent rate, that Bank Rate gets back to 4 – 5% before the next recession and that all assets purchased through QE have been sold off by then. The first Bank Rate increase is expected in Q3 2009.
- g) The major risk to this scenario would be a lack of supply of bank credit. However, it is felt that the Bank of England is on alert to ensure that this does not happen and would continue various measures to assist the expansion of credit.

This assessment indicates that the recovery is by no means clear at present. Factors detailed here suggest the beginnings of slow improvement but are by no means positive about the immediate future prospects of the economy.

#### Evaluation of 2010/11

In formulating and executing the strategy for 2010/11, the Council will have regard to the DCLG's Guidance on Local Authority Investments issued in March 2004 (under review consultation) and CIPFA's Code of Practice on Treasury Management 2009 (Revised).

CIPFA's Treasury Management Code of Practice states that "in balancing risk against return, local authorities should be more concerned to avoid risks than maximise returns". 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 aim to achieve the 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 to the Report of the Head of Finance, under the 'Specified' and 'Non-Specified' investment categories, as per the DCLG guidance. Specified instruments are those that are commended as being suitable for use by local authorities in the DCLG guidance. Non-specified instruments 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 to ratings of all three 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 on negative rating watch (i.e. there is a reasonable probability of a rating change in the short term and the likelihood of that change being negative) and it is currently near the floor of the minimum acceptable rating for placing investments with that body, 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 downgrade of an institution or removal from the Council's lending list.

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 above.

The Head of Finance 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 has not been exercised to date.

Based on the information in the table at 1.6.2 above there will be a balance of £7.7m invested at the start of 2010/11. Deposits that mature in 2010/11 are as follows:-

<b>Investment</b>	<b>Total Invested £m</b>	<b>2010/11 £m</b>
Long Term Investments	5.0	5.0
Short Term Investments	2.7	2.7
Totals	7.7	7.7
Use of Balances/Capital Receipts		5.1

These maturities will therefore cover the anticipated use of cash balances for the periods above. This leaves only £2.6m available for investment, along with day to day cashflow management funds.

As mentioned previously interest rates are projected to rise during 2010 and continue this trend through March 2013. The budget for investment



income is based on this projection. Over the same period current money market rates are as follows:-

<i>(Rates based on an investment of £1m)</i>	<b>Market Rate</b>	<b>Forecast Base Rate</b>
Month deposit (Feb 10)	0.50%	0.50%
Month deposit (April 10)	1.05%	0.50%
Month deposit (July 10)	1.40%	0.50%
Year deposit (Jan 11)	1.60%	1.00%
Year deposit (Jan 12)	1.95%	3.25%
Year deposit (Jan 13)	2.80%	4.25%

This table shows deals up to 1 year offer good value, but after this time, with the increases in base rate, they are less promising. It has been suggested by the Council's Treasury Management advisors to keep investments under a year. The exception would be the use of "core" cash for 1 year where rates suggest a premium over expected base rates over the period

The current budget strategy for 2010/11 onwards identifies a need for prudential borrowing in future years. Within the code CIPFA suggests 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.

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

	<b>Dec 09</b>	<b>Mar 10</b>	<b>Jun 10</b>	<b>Sep 10</b>	<b>Dec 10</b>	<b>Mar 11</b>	<b>Mar 12</b>	<b>Mar 13</b>
	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>
Bank Rate	0.50	0.50	0.50	0.75	1.00	1.50	3.50	4.50
5 yr PWLB Rate	2.85	3.05	3.20	3.30	3.40	3.60	4.60	4.85
10 yr PWLB Rate	3.90	4.00	4.05	4.15	4.30	4.45	5.00	5.15
25 year PWLB Rate	4.40	4.55	4.65	4.70	4.80	4.90	5.20	5.35
50 year PWLB Rate	4.45	4.60	4.70	4.75	4.90	5.00	5.30	5.45

### Strategy for 2010/11

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

Changes to Counterparty List – Appendix C to the Report of the Head of Finance

- a) Reduce the number of building societies on the list from top 30 to top 10. This is due to building societies being an un-specified investment as they are low rated, with the exception of Nationwide. To help local

businesses, it is suggested that Kent Reliance remains, even though they are rated 13.

b) Use the Council's Treasury Management Consultant's scheme for rating of institutions for creditworthiness which uses a sophisticated modeling approach with credit ratings from all 3 rating agencies, Moodys, Fitch and Standard & Poors, along with Sovereign ratings, CDS spreads and credit watches.

c) Group limits to be 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 (i.e. Royal Bank of Scotland and National Westminster Bank). The group limit will be the highest individual credit criteria for the group.

d) The Head of Finance be given delegated responsibility to add or withdraw institutions from the Counterparty List when ratings change either advised by the Sector or from another reliable market source.

#### Adoption of Reporting Arrangements

a) In formally adopting the revised code it is necessary to agree revised reporting arrangements and responsibilities. These cover the scrutiny, adoption, monitoring and amendment of the strategy and can be detailed as follows:-

#### Scrutiny by Audit Committee

*Treasury Management Strategy* – annual in advance of adoption.

*Treasury Management Performance* – mid year and year end.

#### Adoption and Monitoring by Cabinet

*Treasury Management Strategy* – annually in advance of year for adoption.

*Quarterly Budget Monitoring Reports* – quarterly review of Treasury Management as part of greater budget monitoring.

*Treasury Management Performance* – outturn report after year end.

#### Adoption and Monitoring by Council

*Treasury Management Strategy* – annually in advance of year, as recommendation from Cabinet.

*Treasury Management Performance* – mid year and year end outturn recommendation from Audit Committee.

#### Amendments under Delegation

*Treasury Management Strategy* – As delegated to the Head of Finance and the Cabinet Member for Corporate Services.

## Focus of Treasury Management Activity in 2010/11

- a) Invest funds short term (up to 1 year) so that funds are available to invest when rates increase.
- b) Use of up to £2m from core cash balances to be invested for 1 year if rates are at a premium over predicted base rates and funds are available for the term.
- c) Identification of opportunity to borrow subject to the codes principles, suitable carrying cost mitigation and specific approval from Cabinet.

## Treasury Indicators

The Indicators important to the Treasury Management strategy are detailed on the attached Appendix D to the Report of the Head of Finance, 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 indicator 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 indicator 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 Advisers, and the background to this is dealt with in more detail in the proposed investment strategy earlier in this report.
- g) Maturity Structure of New Fixed Rate Borrowing during 2010/11 – this indicates the assumed maturity structure for any borrowing that may occur at a fixed rate of interest, during 2008/09. 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 Scrutiny Manager by: xxxxxxxxxx.
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