MAIDSTONE BOROUGH COUNCIL

RECORD OF RECOMMENDATION OF THE CABINET

TO COUNCIL

Recommendation Made: 11 February 2009

TREASURY MANAGEMENT STRATEGY 2009/10 – 2011/12

Issue for Decision

In accordance with CIPFA's Code of Practice on Treasury Management, the Council is asked to consider and endorse a Treasury Management Strategy for 2009/10 including a series of prudential indicators required under the 2003 Prudential Code for Capital Finance.

Recommendation Made

1. That the proposed strategy, as shown below, is agreed:
   - Counterparties
     Retain current criteria plus:

     Nationalised Banks and Guaranteed Deposits – As the Sovereign ratings take precedent over the bank's own ratings, we would use these for our lending criteria.

     Supported banks – Use the same lending criteria as the Authority uses for building societies to ensure risk of rate changes are kept to a minimum.

   - Investment Strategy
     Invest funds short term (up to 1 year) so that funds are available to invest when rates increase.

   - Borrowing Strategy
     Agree potential borrowing, either external or using internal balance/balance sheet item resources of up to £4m.

2. That the prudential indicators detailed in Appendix A, as amended by the Budget Strategy Report, be agreed.

3. That the Chief Finance Officer 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.

4. That the Council's Treasury Management Practices be amended to reflect the recommendations made above.

Reasons for Recommendation

On an annual basis, at this time, Cabinet agrees to recommend to Council the general direction for Treasury Management in the following financial year. The detailed administration of the strategy will be undertaken in accordance with the Treasury Management Practices endorsed by Council within CIPFA's Code of Practice on Treasury Management.

The code gives greater freedom to authorities to decide their own levels of affordable borrowing, and encourages them to borrow for capital investment if they need to do so and if they can afford to do so. The indicators are set to allow authorities to monitor their borrowing and any other long-term liabilities on an on-going basis

The Prudential Code for Capital Finance requires the Council to set a number of Prudential Indicators. The Prudential Code also requires the indicators, and therefore this strategy, to be for an extended period of three years but with an annual review. The indicators are shown in Appendix A.

Section 3 of the Local Government Act 2003 sets a duty for the Authority to determine an affordable borrowing limit. The Prudential Code for Capital Finance identifies one indicator "The authorised limit for external debt" as satisfying the requirements of that duty.

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 limited to a level which is affordable within the projected income of the Council for the foreseeable future.

The Treasury Management Strategy and the Prudential Indicators are based upon the ongoing use of the capital receipt from the stock transfer in February 2004, and other receipts, as previously agreed by Cabinet, and also proposals in the Corporate Revenue and Capital Budgets 2009/10 onwards reported elsewhere on this agenda.

2008/09 Strategy

The current strategy agreed by Council in February 2008 for investments allows for a combination of short term (less than 1 year) and long term (greater than 1 year) investments. This strategy was devised in the knowledge that there was a very clear and known spending profile for the resources available, particularly from capital receipts. The strategy was agreed as follows:

Invest a maximum of £5m over a maximum time period of 2 years, to give some further certainty to investment income as there is a risk of a further cut in rates during 2008. It is considered prudent to have a degree of flexibility in the strategy given the possibility of a cut in rates. As shown above market rates for 2 and 3 year investments are currently around the 5% projected base rate level that the investment income budget is based on.

Once these deals have been made any sums left will be utilised for short term (less than 1 year) cashflow purposes. This will allow some flexibility to take advantage of any temporary increases in money market rates during the course of the year.

There will be no planned borrowing, other than for short-term cashflow purposes. The Council is currently debt-free.

This strategy and accompanying agreement on counterparties credit rating, and limits on amounts and duration of investments has served the Authority well during 2008/09. It has allowed investment returns to be maximised against strong security criteria on counterparties.

Current Cashflow Performance

Detailed below is the Council's current portfolio position at 1st February 2009.

	Principal **£m**	Average Rate **%**
Total Debt	0.0	
Short-term Investments	27.2	3.98
Long-Term Investments	11.6	5.83
Total Investments	38.8	

Throughout 2008/09 the level of investments has remained high, with an average balance of £32.7m invested over the course of the year. This covers investment of balances, capital receipts and other balance sheet assets. However it is higher than anticipated as a consequence of slippage in both revenue and capital expenditure, as reported to Cabinet in various budget monitoring reports.

The level of investments at 1st April 2008 was £26.4m 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 spend on the capital programme. In overall terms, the level of investment at March 2009 is projected to reduce to approx £16.9m. This takes into account the effects of using existing capital receipts to fund the capital programme and utilising balances to fund revenue costs, as detailed in the Budget Strategy Report.

Higher than expected levels of investments will generate investment income in 2008/09 of approximately £1.8m, compared to an original estimate of £1.6m. This increase is in part a consequence of the credit crunch, as well as slippage in the forecast revenue and capital expenditure. Money Market Rates rose as high as 6.7% for short term investments during the period of the crisis in the banking sector.

The only borrowing that has taken place during 2008/09 has been for short-term cashflow purposes.

Updated Cashflow Projection

A cashflow projection up to March 2011 has been created reflecting spending proposals in the Budget Strategy Report. The cashflow projection shows that anticipated investment income will be £0.7m in 2009/10 and £0.4m in 20010/11, based on all known factors at this point in time. The substantial reduction relates to issues around funding of the Capital Programme and the reductions in investment returns. The impact of reduced investment income has been a material factor in the Budget Strategy for 2009/10 and future years.

Based on the current cashflow projection the Council has anticipated year end cash balances available for investment totalling £16.9m at present, comprising basically of balances and capital receipts. Based on current forecasts it is anticipated that this will be utilised or available for potential problems as follows:

Use in 2009/10	£m
Capital Receipts	7.0
Capital Grants	2.0
Balances	0.9
Total	9.9

Ongoing	
Balances	4.8
Collection fund and other Balance Sheet Items	2.2
Total	7.0

Base Rate Forecast

	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%

It is the view of the Council's Treasury Management advisors that base rates will fall from current levels because of the intensifying global recession. Starting in 2009 at 2.00%, Bank Rate is forecast to fall to 0.5% in Quarter 1 2009. It is then expected to remain there until starting to rise gently up from Quarter 2 2010 till it reaches 4.0% in Quarter 1 2012. There is a downside risk to these forecasts, if the recession proves to be deeper and more prolonged than currently expected.

Economic Background

Nationally, 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 MPC had been very concerned about Consumer Price Index inflation, which had been rising sharply on the back of higher commodity and food prices. Bank rates reached a peak of 5.75% in July 2007 after which cuts of 0.25% occurred in December 2007 and February and April 2008 before the major cuts in the autumn. These cuts have accompanied reductions in the various measures of inflation.

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.

The strength of the banking crisis, pre-empted by the collapse of Lehmans in New York, eventually drove the MPC to cut interest rates by 0.50% on October 8th in concert with the Federal Reserve, the 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 substantially slashed by 1.50% on 6th November, 1.00% on 4th December and 0.50% on 8th January 2009.

It is now acknowledged that the economy is formally in recession and the immediate prospect is for further reduction in the Base Rate and inflation.

Proposed Strategy 2009/10

In formulating and executing this strategy the Council will have regard to the ODPM's Guidance on Local Authority Investments issued in March 2004 and CIPFA's Code of Practice on Treasury Management and any update and lessons learnt from the Icelandic Banks situation experienced in 2008.

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 A of the Report of Management Team under the 'Specified' and 'Non-Specified' investment categories, as per the ODPM guidance referred to above.

Specified instruments are those that are recommended as being suitable for use by local authorities in the ODPM guidance. Non-specified instruments are included at the Council's discretion, based on guidance from our Treasury Management advisors.

The Council uses credit ratings from an agency called Fitch. The banks and certain building societies are rated for their credit worthiness on Long Term, Short Term, Individual and Support ratings. A list of these and their meanings are listed on Appendix B of the Report of Management Team. As well as using these ratings the Authority also look at market intelligence provided to the Borough through money brokers and the Council's Treasury Management Advisors.

Due to the banking crisis a number of banks have been removed from the Council's lending list due to their ratings falling below the required minimum level. However, there are a number of developments which require separate consideration and approval for use:-

- **Nationalised Banks –** Individual ratings have been reduced to an F as these have previously failed and are now owned by the Government. Short term ratings are F1+ as they take on the credit worthiness of the Government itself. They also have a support rating of 1, in other words, on both accounts, they have the highest ratings possible.
- **Blanket Guarantee on all Deposits –** Some countries have supported their banking system by giving a blanket guarantee on **ALL** deposits, eg, Ireland. The sovereign rating of that Country then takes precedence over the individual credit ratings for the banks covered by that guarantee. Irish Sovereignty has been put on negative watch due to the Nationalisation of Anglo Irish Bank. It is

uncertain that the Irish Government would be able to offer the same package to another bank.

- **UK Banking System Support Packages –** The UK Government has **NOT** given a blanket guarantee on all deposits but has underlined it's determination to ensure security by supporting eight named banks with a £500bn support package. The banks are Abbey, Barclays, HBOS, Lloyds TSB, HSBC, Nationwide Building Society, RBS and Standard Chartered. The Treasury Management Advisors have suggested that the UK Government would not allow these larger banks to become insolvent, so suggesting using these banks but keeping smaller funds for short periods of time to reduce the risks.
- **Building Societies –** Currently the Council has the top 30 Building Societies on its lending list and has been advised by the Treasury Management Advisors to keep these on the list. Even though they are not rated in the same way as Banks, they are a low risk and keeping smaller funds short term would minimise any risk.
- **Other Countries –** The US, Countries within the EU and Switzerland (and other countries) are currently providing major support packages.

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, as has been mentioned previously 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.

There are a number of alternatives that have been discussed with the Council's Treasury Management advisors during the formulation of this strategy, which have been included in the list of Specified and Non-specified instruments referred to above. These are as follows (full definitions are shown at Appendix A of the Report of Management Team):

- Corporate Bonds
- Callable Structures
- Callable Range Accruals
- Certificates of Deposit (CDs)
- Snowballs

The Chief Finance Officer 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 above there will be a balance of £16.9m invested at the start of 2009/10. £11.5m of this figure is already invested in Eurosterling Bonds and long-term deposits that mature as follows:

Repayment profile maturities

Investment	**Total invested £m**	**2009/10 £m**	**2010/11 £m**
Eurosterling Bonds	**4.5**	4.5	-
Long-term investments	**7.0**	2.0	5.0
Short Term investments	**5.4**	5.4	-
Totals	**16.9**	11.9	5.0
Use of Balances/Capital receipts	-	9.9	-

These maturities will therefore cover the anticipated use of cash balances for the periods above. This leaves only £2.0m available for investment, along with day to day cashflow management funds.

As mentioned previously interest rates are projected to fall during 2009 before rising during 2010. The budget for investment income is based on this projection. Over the same period current money market rates are as follows:

(Rates based on an investment of £1m)	**Market Rate**	**Forecast Base Rate**
1 month deposit (Mar 09)	1.50%	0.50%
3 months deposit (May 09)	2.00%	0.50%
6 month deposit (Aug 09)	2.15%	0.50%
1 year deposit (Jan.10)	2.30%	0.50%
2 year deposit (Jan.11)	2.17%	1.75%
3 year deposit (Jan.12)	2.51%	4.00%

However, recent experience has shown that over time actual interest rates can vary considerably from what was originally forecast. As was mentioned previously the forecast for the current base rate this time last year was 4.75%, compared to the actual current rate of 1.50%.

The £2.0m available for investment in 2009/10 is subject to changes in future spending projections. In addition forecast rates are also subject to change, as has been shown in the past year.

To deal with the ongoing Capital Programme it may be necessary to look into borrowing to fund these projects. Where investments are in excess of borrowing requirements, internal borrowing and access to cash from maturing investments within the year, may be worth considering. This will have the benefits of reducing exposure to interest rate and credit risk.

Based on these issues, and following consultation with the Council's Treasury Management advisors the following strategy is recommended:

- Counterparties

    Retain current criteria plus:

    Nationalised Banks and Guaranteed Deposits – As the Sovereign ratings take precedent over the bank's own ratings, we would use these for our lending criteria.

    Supported banks – Use the same lending criteria as the Authority uses for building societies to ensure risk of rate changes are kept to a minimum.

- Investment Strategy

    Invest funds short term (up to 1 year) so that funds are available to invest when rates increase.

- Borrowing Strategy

    Agree potential borrowing, either external or using internal balance/balance sheet item resources of up to £4m.

<u>Prudential Indicators</u>

The indicators important to the Treasury Management strategy are detailed on the attached Appendix C, 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 or 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) Capital Financing Requirement

This indicator measures the Council’s underlying need to borrow for capital purposes based on past, present and future financing decisions. This indicator must be affordable within the Operational Boundary. The receipt from the transfer of housing stock to Maidstone Housing Trust and other receipts directly affect this indicator and this means the Council has no current plans to borrow.

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 2009/10

This indicates the assumed maturity structure for any borrowing that may occur at a fixed rate of interest, during 2009/10. 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 not recommended

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 educing investment levels.

Background Papers

Working papers held in the Corporate Finance office.

These documents are available at the Council offices.