MAIDSTONE BOROUGH COUNCIL

REPORT OF THE CABINET HELD ON 08 FEBRUARY 2012

TREASURY MANAGEMENT STRATEGY 2012/13

Issue for Decision

To consider, in accordance with CIPFA's Code of Practice on Treasury Management 2009 (Revised), the Draft Treasury Strategy for 2012/13 including a series of Treasury and Prudential Indicators, as recommended by Audit Committee.

Recommendation Made

That the Treasury Management Strategy for 2012/13, as detailed below, be approved including the Counterparty List attached at Appendix A, the Prudential Indicators attached at Appendix B and the Specified and Non-Specified Investments attached at Appendix C.

Reasons for Recommendation

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 report considers the proposed strategy for 2012/13 onwards along with current guidance from CIPFA and the DCLG.

The primary requirements of the Code are as follows:

a) Receipt by full Council of an annual Treasury Management Strategy that includes 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 agreed process for approval at this Council is:

a) Audit Committee will consider, as part of their monitoring role, the initial draft and make recommendations to Cabinet.

b) Cabinet will consider the draft and any recommendations from Audit Committee and recommend to Council

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

2011/12 Strategy

The Strategy for 2011/12 set out the following objectives:-

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

d) Group limits placed on institutions within the same ownership group;

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 Treasury Management (the Council's advisors) or from another reliable market source.

Current Cashflow Performance

At the November 2011 Audit Committee meeting the mid-year performance report included details for 2011/12 of the position as at 30th September 2011. Listed below is an update on that position.

The Council's current investment position is given in the table below.

	£m	**%**
Investments as at 1st April 2011	**21.0**	
Investment Balance as at 31st Dec 2011	**33.6**	
Investment Income as at 31st Dec 2011	**0.23**	
Ave Balance/Rate of Investments during year	**27.0**	**1.1**
Est. Investments as at 31st March 2012	**17.0**	

All investments have been on a short-term basis to be used, as agreed within the Strategy.

£3m of core cash funds were invested for 1 year with Lloyds TSB (part nationalised bank).

The average rate of interest received on the council's investments over the period was 1.1% compared to a forecast level of 1.0%. Investment income as at 31st December 2011 is £230,000 compared to a budget of £185,000.

There has been continued concern with all financial institutions within the UK having their credit ratings reduced. This is mainly due to the current economic situation in Europe. It is Sector's view that the semi nationalised banks, e.g. RBS and Lloyds groups, will be safe but there is uncertainty with other UK institutions. With this in mind, the Head of Finance and Customer Services (in line with his delegated authority) has reduced the exposure to these other institutions down to a maximum of three month term deposits, as recommended by Sector, and the use of building societies down from top 10 to top 5. This ensures that the greater part of the Council's finances will be very liquid and placed with higher rated institutions.

Based on the current cash flow projection the Council has anticipated cash balances at 1st April 2012 available for investment totalling £17m.

Cash Flow Projection to 2014/15

A cash flow projection up to March 2015 has been created reflecting the spending proposals in the Budget Strategy 2012/13 onwards. The cash flow projection shows that anticipated investment income will be consistently £0.25m per annum over the period from 2012/13 to 2014/15. This is based on the anticipated sales of Council fixed assets and interest rates remaining as forecast.

There is no planned borrowing to fund the capital programme up to March 2015.

Annual Investment Strategy

In formulating and executing the strategy for 2012/13, the Council will have regard to the DCLG's guidance on Local Government Investments and the 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.

The Council, in conjunction with its treasury management 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 use for further 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.

The use of leading building societies for investment purposes has already been reduced by the Head of Finance & Customer Services from top 10 down to top 5 ranked on asset size of the society. In considering the effectiveness of this decision an alternative ranking system has been identified that uses a combination of management expenses of the group, as shown within the Income and Expenditure Account, as well as the asset size. This is a better indication of how the group would bear within stressful economic times. The draft strategy for 2012/13 proposes the use of this measure. This has been discussed with the Council's treasury management advisors.

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.

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 2012/13 and the total of this balance which will be needed to fund the revenue/capital expenditure.

Investment	**2012/13 £m**
Short Term Investments at start of Year	17.0
Use of Balances/Capital receipts	12.0
Total Core Cash	**5.0**

These maturities will therefore cover the anticipated use of cash balances for the period and leave £5.0m available for investment, along with day to day cash flow management funds.

Interest Rate Forecast

As part of their service Sector Treasury Management assist the Council to formulate a view on interest rates. Below is a table which forecasts short term (Bank Rate) and longer term fixed interest rates that reflects their current view on the future.

Annual Average %	Bank Rate	Money Rates		PWLB Borrowing Rates		
		3 month	1 year	5 year	25 year	50 year
March 2012	0.50	0.70	1.50	2.30	4.20	4.30
June 2012	0.50	0.70	1.50	2.30	4.20	4.30
Sept 2012	0.50	0.70	1.50	2.30	4.30	4.40
Dec2012	0.50	0.70	1.60	2.40	4.30	4.40
March 2013	0.50	0.75	1.70	2.50	4.40	4.50
June 2013	0.50	0.80	1.80	2.60	4.50	4.60
Sept 2013	0.75	0.90	1.90	2.70	4.60	4.70
Dec 2013	1.00	1.20	2.20	2.80	4.70	4.80
March 2014	1.25	1.40	2.40	2.90	4.80	4.90
June 2014	1.50	1.60	2.60	3.10	4.90	5.00

Growth in the UK economy is expected to be weak in the next two years and there is a risk of a technical recession (i.e. two quarters of negative growth). Bank Rate, currently 0.5%, underpins investment returns and is not expected to start increasing until quarter 3 of 2013 despite inflation currently being well above the Monetary Policy Committee inflation target. An export led recovery appears unlikely due to the Eurozone sovereign debt crisis depressing growth in the UK's biggest export market. The Comprehensive Spending Review, which seeks to reduce the UK's annual fiscal deficit, will also depress growth during the next few years.

This uncertain economic outlook has several key treasury management implications:

- The Eurozone sovereign debt difficulties, most evident in Greece, provide a clear indication of much higher counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2012/13;
- Borrowing interest rates are currently attractive, but may remain low for some time. The timing of any borrowing will need to be monitored carefully.

Strategy for 2012/13

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

The counterparty list – attached as Appendix A.

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

b) 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.

c) 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.

d) A reduction in overseas institutions due to the uncertainty of Sovereignty status', with the exception of Svenska Handelsbanken, a AAA rated Swedish Organisation with whom the Council currently has funds.

e) The top 5 Building Societies, ranked using the management expenses and asset size ranking.

Focus on Treasury Management 2012/13

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. This would leave a balance of £2m if there were to be any unexpected events.

c) There is no borrowing assumed within the 2012/13 strategy.

Treasury Indicators

The Indicators are detailed at Appendix B, the most important of which are listed below. The upper and lower limits are set with reference to the peaks and flows of cash flow 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 cash flows 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 2012/13

This indicates the assumed maturity structure for any borrowing that may occur at a fixed rate of interest, during 2012/13. As any borrowing is expected to be for cash flow purposes only it will be short term borrowing at variable rates.

Investment instruments identified for potential use in the financial year are listed at Appendix C under the 'Specified' and 'Non-Specified' investments categories, as per DCLG'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.

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 may possibly benefit from security of investments, diversification of investment instruments, liquidity management and the potential of enhanced returns. 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.