AGENDA ITEM 7

EAST HERTS COUNCIL

JOINT MEETING OF SCRUTINY COMMITTEES - 19 JANUARY 2010

REPORT BY EXECUTIVE MEMBER FOR RESOURCES AND INTERNAL SUPPORT

7. TREASURY MANAGEMENT STRATEGY STATEMENT 2010/11 AND MINIMUM REVENUE PROVISION POLICY STATEMENT

WARD(S) AFFECTED: ALL

Purpose/Summary of Report

- The report sets out the 2010/11 Treasury Strategy Statement and Annual Investment Strategy together with the setting of Prudential Indicators.

RECOMMENDATIONS FOR JOINT MEETING OF SCRUTINY COMMITTEES:	
(A)	**the 2010/11 Treasury Management Strategy Statement and Annual Investment Strategy and Prudential Indicators for East Herts Council be approved; and**
(B)	**the Policy on Minimum Revenue Provision (MRP) be approved.**

1.0 Background

1.1 The Local Government Act 2003 requires the Council to ‘have regard to’ the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council’s capital investment plans are affordable, prudent and sustainable.

1.2 The Act therefore requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (included as paragraph 2.10); this sets out the Council’s policies for managing its investments and for giving priority to the security and liquidity of those investments.

2.0 Report

2.1 The suggested strategy for 2010/11 in respect of the following aspects of the treasury management function is based upon the Treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor. The strategy covers:

- treasury limits in force which will limit the treasury risk and activities of the Council;
- Prudential Indicators;
- the current treasury position;
- the borrowing requirement;
- prospects for interest rates;
- the borrowing strategy;
- debt rescheduling;
- the investment strategy; (including fund manager review);
- Minimum Revenue Provision (strategy).

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 increases in charges to revenue from:

1. increases in interest charges caused by increased borrowing (or reduced interest earnings where capital receipts are used) to finance additional capital expenditure; and

2. any increases in running costs from new capital projects are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

2.2 Treasury Limits for 2010/11 to 2012/13

2.2.1 It is a statutory duty under S.3 of the Local Government Act 2003 and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the "Affordable Borrowing Limit". In England and Wales the authorised limit represents the legislative limit specified in the Act.

2.2.2 The Council must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax levels is ‘acceptable’.

2.2.3 Whilst termed an “Affordable Borrowing Limit”, the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.

2.3 Prudential Indicators for 2010/11 - 2012/13

2.3.1 The following prudential indicators (in table below) are relevant for the purposes of setting an integrated treasury management strategy.

2.3.2 Members are asked to note that the fall in the ratio of financing costs to net revenue spend, reflects the usage of capital receipts and the lower rate of return on investments. This increases in the latter years with rises in interest rates.

2.3.3 The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. This was adopted on March 2002 by the full Council.

PRUDENTIAL INDICATOR	**2008/09**	**2009/10**	**2010/11**	**20011/12**	**2012/13**
(1) EXTRACT FROM BUDGET	**£’000**	**£’000**	**£’000**	**£’000**	**£’000**
	Actual	**Probable outturn**	**Estimate**	**Estimate**	**Estimate**
Capital Expenditure	4,087	7,550	6,391	4,606	3,768
Ratio of financing costs to net revenue stream	(25.67%)	(8.96%)	(6.25%)	(9.87%)	(11.73%)
Net borrowing requirement					
brought forward 1 April	(69,695)	(68,336)	(60,336)	(54,336)	(51,836)
carried forward 31 March	(68,336)	(60,336)	(54,336)	(51,836)	(50,000)
in year borrowing requirement – reduction in amounts invested	1,359	8,336	6,000	2,500	1,836

Capital Financing Requirement as at 31 March	(40,764)	(44,794)	(44,494)	(43,494)	(40,459)
Incremental impact of capital investment decisions					
Increase in council tax (band D) per annum	£5.07	£3.27	£3.47	£3.20	£3.00
(2) TREASURY MANAGEMENT	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Authorised limit for external debt -					
borrowing	16,700	17,000	17,000	17,000	17,000
other long term liabilities	7,300	3,300	3,300	3,300	3,300
TOTAL	24,000	21,300	20,300	20,300	20,300
Operational boundary for external debt -					
borrowing	10,000	10,000	10,000	10,500	10,500
other long term liabilities	7,300	3,300	3,300	3,300	3,300
see above					
TOTAL	17,300	13,300	13,300	13,300	13,300
Upper limit for fixed interest rate exposure					
expressed as either :-					
Net principal re fixed rate borrowing	100%	100%	100%	100%	100%
Investments	95%	95%	98%	98%	98%
Upper limit for variable rate exposure					
Net principal re variable rate borrowing	50%	50%	50%	50%	50%
Investments	95%	95%	95%	95%	95%
Upper limit for total principal sums invested for over 364 days					
(per maturity date)	68,000	68,000	62,000	57,000	55,000

Maturity structure of new fixed rate borrowing during 2010/11	upper limit	lower limit
under 12 months	0%	0%
12 months and within 24 months	0%	0%
24 months and within 5 years	0%	0%
5 years and within 10 years	0%	0%
10 years and above	0%	0%

2.4 Current Portfolio Position

2.4.1 The Council's treasury portfolio position at 31.10.09 comprised:

		Principal		Ave Rate
		£m	£m	%
Fixed rate funding	PWLB	1.5		8.875
	Market	6.0		8.785
			7.5	8.803
Variable rate funding	PWLB	Nil		
	Market	Nil		
Other long term liabilities			6.7	
TOTAL DEBT			14.2	8.803
TOTAL INVESTMENTS			75.823	3.33%

2.5 Borrowing Requirement

2.5.1 Nil in 2010/11 as no borrowing is needed to support capital expenditure. A borrowing requirement will arise in 2011/12 based on expected capital expenditure net of other sources of funding (capital receipts, grants, revenue contributions) in the period to that year end.

2.6 Prospects for Interest Rates

2.6.1 The Council has appointed Sector Treasury Services as treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. The following table gives the Sector central view.

2.6.2 **Sector View** Interest rate forecast – November 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	0.5%	0.5%	0.5%	0.75%	1.0%	1.5%	2.25%	2.75%	3.25%	3.5%
5 yr PWLB Yield	2.85%	3.05%	3.2%	3.3%	3.4%	3.6%	3.85%	4.15%	4.55%	4.6%
10 yr PWLB Rate	3.9%	4.0%	2.75%	4.1%	4.3%	4.45%	4.6%	4.8%	4.9%	5.0%
25 yr PWLB Rate	4.4%	4.55%	4.63%	4.7%	4.80%	4.9%	5.0%	5.05%	3.10%	5.2%

Sector's current interest rate view is that in respect of the Bank Rate:-

- rates are expected to gradually increase during the year.
- to be followed by further rises during the subsequent years.
- there is a downside risk to these forecasts if the recession proves to be weaker and slower than currently expected.

Some commentators are pointing to the large government borrowing requirement as running a risk of the UK's credit rating coming under pressure with a consequential hike in sterling interest rates. The view expressed here makes no assumption that such risk will materially impact on rates over this period.

2.7 <u>Economic background</u>

2.7.1 There is a sharp division of opinion on how quickly the major world economies will recover.

Sector has adopted a more moderate view ie a moderate return to growth. That the risks that long term gilt yields and PWLB rates will rise markedly are high.

There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas:

- degrees of speed and severity of fiscal contraction after the general election;
- timing and amounts of the reversal of quantitative easing;
- speed of recovery of banks profitability and balance sheet imbalances;
- changes in the consumer savings ratio;
- rebalancing of the UK economy towards exporting and substituting impacts.

The overall balance of risks is weighted to the downside ie the pace of economic growth disappoints and Bank Rate increases are delayed and/or lower.

There is an identifiable risk of a double dip recession but this is considered to be a small risk and an extreme view at the current time on the basis of current evidence.

2.8 <u>Borrowing Strategy</u>

2.8.1 It is anticipated that there will be no capital borrowings required during 2010/11. However under the prudential code borrowings are permissible but with a negative Capital Finance Requirement, this would be difficult to justify. The running down of investments also has the benefits of reducing exposure to interest rate and credit risk. This will be continually monitored in conjunction with the treasury advisers.

2.9 <u>Debt Rescheduling</u>

2.9.1 Due to high rates of interest payable on the outstanding £1.5 million PWLB loans and the expected low level of the corresponding discount rates for maturities, any potential restructuring or premature repayment of the loans would be very expensive as their repayment would attract heavy premiums (in excess of £1M).

2.9.2 If the market conditions do change, any opportunities will be investigated, to pursue any potential advantages to the Council.

2.10 <u>Annual Investment Strategy</u>

2.10.1 **Investment Policy**

2.10.1.1 The Council will have regard to the CLG's Guidance on Local Government Investments ("the Guidance") issued in

March 2004 and CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities are:-

(a) the security of capital and
(b) the liquidity of its investments.

The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

2.10.1.2 The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

2.10.1.3 Investment instruments identified for use in the financial year are shown below under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be set through the Council's Treasury Management Practices.

Specified Investments

An investment is a specified investment if it satisfies the conditions set out below:-

(a) The investment is denominated in sterling and any payments or repayments in respect of the investment are payable only in sterling.

(b) The investment is not a long-term investment (maximum of 1 year).

(c) The investment does not involve the acquisition of share capital or loan capital in any body corporate.

(d) Either of the following conditions is met:

(i) The investment is made with the UK Government or a local authority (as defined in section 23 of the 2003 Act) or a parish council or community council.

(ii) The investment is made with a body or in an investment scheme which has been awarded a high credit rating (as specified in the tables below *) by a credit rating agency.

(e) These offer high security and high liquidity.

	*Minimum 'High' Credit Criteria	Use
Debt Management Agency Deposit Facility	-	In-house
Term deposits - UK government	-	In-house
Term deposits - other LA's	-	In-house
Term deposits - banks and building societies**	*Short-term F1 Long-term A, Individual_, Support 1,2,3	In-house and fund managers
Certificates of deposits issued by banks and building societies covered by UK Government guarantee	*Short-term F1 Long-term A, Individual_, Support 1	Fund managers
Certificates of deposits issued by banks and building societies NOT covered by UK Government guarantee	*Short-term F1, Long-term A, Individual _, Support 1,2,	Fund managers
1. Callable deposits	*Short-term F1, Long-term A, Individual _, Support 1,2,3	Fund managers
2. Range trade	*Short-term F1, Long-term AA, Individual _, Support 1,2,3	Fund managers
3. Snowballs	*Short-term F1, Long-term AA, Individual _, Support 1,2,3_	Fund managers
UK Government Gilts	AAA	Fund managers
Bonds issued by multilateral development banks	AAA	Fund managers
Collective Investment Schemes structured as Open Ended Investment Companies (OEICs):		
1. Money Market Funds	*Short-term F1, Long-term A, Individual _, Support 1,2,3	Fund managers
2. Enhanced cash funds	*Short-term F1, Long-term A, Individual _, Support 1,2,3	Fund managers
3. Short term funds	*Short-term F1, Long-term A, Individual _, Support 1,2,3	Fund managers
4. Bond Funds	*AAA	Fund managers
5. Gilt Funds	*AAA	Fund managers
Bonds issued by a financial institution which is guaranteed by the UK government	*AAA	In-house on a 'buy-and-hold basis. Also for use by fund managers
Sovereign bond issues (ie other than the UK govt)	*AAA	Fund managers

	*Minimum 'High' Credit Criteria	Use
Treasury Bills		Fund Managers

** If forward deposits are to be made, the forward period plus the detail period should not exceed one year in aggregate.

Non-Specified Investments:

Do not meet the definition for specified investments i.e. maturities more than 1 year and subsequently the risk is considerably greater. The maximum to be held in each category of non-specified investments is as follows:

	* Minimum Credit Criteria	Use	**Max% of total investments	Max maturity period
Term deposits - other LAs (with maturities in excess of 1 year)		In-house	60%	5 years
Term deposits - banks and building societies (with maturities in excess of 1 year)	*Short-term F1, Long-term AA, Individual _, Support 1,2,3	In-house	80%	5 years
Term deposits with unrated counterparties : any maturity	Used to be unrated building societies and wholly owned subsidiaries)	Not permitted		5 years
Commercial paper issuance by UK banks covered by UK Government guarantee	*Short-term F1, Long-term AA, Individual _, Support 1,2,3	Fund managers		5 years
Fixed term deposits with variable rate and variable maturities				
1. Callable deposits	*Short-term F1, Long-term AA, Individual _, Support 1,2,3	Fund managers	80%	5 years
2. Range trade	*Short-term F1, Long-term AA, Individual _, Support 1,2,3	Fund managers	10%	5 years
3. Snowballs	*Short-term F1, Long-term AA, Individual _, Support 1,2,3	Fund managers	10%	2 years
Certificates of deposits issued by banks and building societies with maturities in excess of 1 year	*Short-term F1, Long-term AA, Individual _, Support 1,2,3	Fund Managers	50%	5 years
UK Government Gilts with	AAA	Fund Managers	100%	10 years

	* Minimum Credit Criteria	Use	**Max% of total investments	Max maturity period
maturities in excess of 1 year				
Bonds issued by multilateral development banks with maturities in excess of 1 year	AAA	Fund managers	40%	10 years
Bonds issued by a financial institution which is guaranteed by the UK government with maturities in excess of 1 year	AAA	Fund managers	40%	10 years
Sovereign bond issues (ie other than the UK govt) with maturities in excess of 1 year	AAA	Fund managers	50%	10 years
Corporate Bonds : **the use of these investments would constitute capital expenditure** (bonds other than government bonds)	*AAA	Not permitted	10%	5 years
Floating Rate Notes : **the use of these investments would constitute capital expenditure unless they are issued by a multi lateral development bank** (ie bonds with interest rate that varies in line with the market rate of interest, reset say every 3 months)	*AAA	Fund Managers but not permitted where the investment would constitute capital investment.	10%	5 years
Property fund: **the use of these investments would constitute capital expenditure**		Not permitted	10%	10 years

** Note: When setting these limits it includes both in-house and externally managed funds.

The Council's external fund managers will comply with the Annual Investment Strategy.

The agreements between the Council and the fund managers additionally stipulate guidelines and duration and other limits in order to contain and control risk. In brief terms these are the maximum investment that are permissible with any one counterparty limited by value or percentage, with the exception of the UK Government.

The Council uses Fitch ratings to derive its criteria. Where a counterparty does not have a Fitch rating, the equivalent Moody's (or other rating agency if applicable) rating will be used. All credit ratings will be monitored **daily**. The Council is alerted to changes in

Fitch ratings through its use of the Sector creditworthiness service. If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

In addition to the use of Credit Ratings the Council will be advised of information about movements in the pricing of Credit Default Swaps against the ITRAXX benchmark (issued by Bloombergs) and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution.

2.10.2 **In-House Funds**

In-house funds are mainly cash flow derived and therefore investments will be made with reference to short term interest rates (ie rates for investments up to 12 months). Current policy is to place funds only with the external cash fund manager SWIP but other investments may be placed in accordance with the tables set out above.

2.10.3 Interest Rate Outlook: Sector is forecasting that Bank Rate is now on an upward trend from 0.5% to 1.5% in March 2011. This will continue with a rate of 3.5% at December 2011. It would therefore be prudent to look at the period of investments and their interest rates against this background information. For 2010/11 the Council has assumed investment return of 2.75% on the investments made in house. For the medium term planning process rates of 3.5% (2011-12) 4% (2012-13) and $4^1/_2$% (2013-14) have been assumed.

For its cash flow generated balances, the Council will seek to utilise its business reserve accounts in order to benefit from the compounding of interest and investing short-term in money market funds through our Fund Manager.

2.11 **Fund Managers Review and Forecasts**

East Herts Council employ two fund managers Investec and Scottish Widows (SWIP).

2.11.1 **Investec Asset Management**

In the first quarter Investec focussed on the CD market and the floating rate notes and moved into the gilt market in the second quarter.

2.11.2 Judging by the activity in the second quarter current financial year it appears that Investec is slowly moving away from its ultra cautious approach.

2.11.3 This performance is set out below:

	Merrill Lynch 03 yr gilt* benchmark	**East Hertfordshire Investec fund net of fees**	Variance
Quarter ended 30/06/2009	(0.07%)	**0.25%**	0.32%
Quarter ended 30/09/2009	1.55%	**0.45%**	(1.10%)
Half Year 2009-10	1.48%	**0.70%**	(0.78%)

For the year 2009/10 it is estimated that a return of 1.25%-1.6% will be made. For 2010/11 a range of returns between 1.5% and $2^{1}/_{2}$% is estimated.

2.11.4 **Scottish Widows Investment Partnership**

The good performance stemmed from the changes in the risk environment during the quarter. The returns in money market funds were achieved with the value made in floating rate notes and some long dated paper which benefited from the move down the yield curve.

It is unlikely that performance in the first half of the year will be repeated for the rest of the year.

	7-day LIBID* benchmark	**East Hertfordshire SWIP fund net of fees**	Variance
Quarter ended 30/06/2009	0.11%	**1.45%**	1.34%
Quarter ended 30/09/2009	0.11%	**1.38%**	1.27%
Half Year 2009-10	0.22%	**2.83%**	2.61%

For 2009/10 an outturn of 3.5%-4.0% is forecast. For 2010/11 1.5%-2.0% return is estimated.

2.11.5 At 31 October 2009 SWIP's holding on behalf of the Council was £40,749,644 whilst Investec managed £35,223,368. As can be seen with a 0.25% variance on Fund Manager's prediction a variance of around £190,000 either way is effected on the Council's Revenue

Budget.

2.11.6 **End of year Investment Report**

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

2.11.7 Summary of Strategy

2.11.8 No new borrowings to finance capital expenditure until capital receipts and other funding has been fully applied. This will be continually monitored in conjunction with the Treasury Advisers.

2.11.9 Any debt rescheduling opportunities will be investigated.

2.11.10 Fund Managers to trade gilts and Certificate of Deposit, Treasury Bills, Money Market Funds with objective of maximising yields.

2.11.11 Having regard to potential interest rate movements as set out in 2.10.3 above, investments will be made (depending on cash flow) with these expectations forming the basis of the investment decision.

2.11.12 A 2.75% return has been assumed in 2010/11 for budgetary setting. However this is subject to final review prior to the Council setting its budget.

2.12 Minimum Revenue Provision (MRP)

The Council needs to agree options for the MRP (the provision to repay debt) annually. Capital receipts from stock transfer, mean that no new borrowings are anticipated in the medium term. The method which is most appropriate will be considered when any new borrowings are entered into.

2.12.1 For capital expenditure incurred on or after 1st April 2009, which is financed by borrowing or credit arrangements, one of the following options will be used:-

Option 1 – Asset Life Method

Here equal annual instalments of MRP will be made over the estimated life of asset financed by borrowing. Under this method, the concept of an “MRP Holiday” makes it debut. This provides the ability for an authority to defer MRP on a newly constructed building or infrastructure asset until the asset comes into service.

Option 2 – Depreciation Method

Using this approach will require an authority to charge MRP in accordance with the standard rules for depreciation accounting. As with Option 1 the “MRP Holiday” will be available for assets yet to be brought into service.

2.12.2 Under new regulations the method by which the Council provides for the repayment of it’s borrowings for capital expenditure incurred before 1st April 2008, either of the two methods below can be used:-

Method 1 - Regulatory

Where debt is supported by RSG, authorities will be able to continue using the formulae used in the current regime, since the supported borrowing element of the RSG is also calculated in this way.

Method 2 – Capital Financing Requirement

This method will be based upon 4% of an authority’s non-housing CFR at the end of the preceding financial year. Where the CFR is negative or nil, no MRP will be required as is the case at present.

This in the past has resulted in a nil requirement and the indications are that this will remain the same.

3.0 Implications/Consultations

3.1 Information on corporate issues and consultation associated with this report can be found within **Essential Reference Paper ‘A’ (Page 7.17).**

Background Papers
None.

Contact Member:	Councillor Michael Tindale, Executive Member for Resources and Internal Support.
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Report Author:	Paul Mitchell - Principal Accountant, Extn: 2059.

Contribution to the Council's Corporate Priorities/Objectives:	**Fit for purpose, services fit for you** *Deliver customer focused services by maintaining and developing a well managed and publicly accountable organisation.*
Consultation:	The Strategy Statement has been drawn up with reference to information from out Treasury Advisers.
Legal:	There are no legal implications in the report.
Financial:	As set within the report.
Human Resource:	There are no Human Resources implications in the report.
Risk Management:	A prudent (average) assumption of 2.75% has been used on the sensitive interest receivable rate based on the information and advice available. A variation of 0.25% (either way) would result in a budget variance of some £172,500. If cash flows vary by £1m then the result is a movement of £25,000 per annum.