Report to:

Cabinet

Council

Audit and Corporate Governance Committee

South Oxfordshire District Council

Listening Learning Leading

Report of Head of Finance

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AGENDA ITEM NO 11

To: CABINET 14 February 2011
To: COUNCIL 24 February 2011
To: AUDIT AND CORPORATE GOVERNANCE COMMITTEE 22 March 2011

Treasury management strategy 2011/2012

Recommendations:

That cabinet recommends council to approve:

1. the treasury management strategy 2011/12, incorporating the annual investment strategy, which is contained within appendix A of the report of the head of finance to cabinet on 14 February 2011,

2. The prudential indicators and limits for 2011/12 to 2014/15, which are contained within appendix A and annexe 2 of the report of the head of finance to cabinet on 14 February 2011.

That audit and corporate governance committee:

3. Scrutinise the treasury management strategy and policy and if required make recommendations for amendment at the next council

Purpose of report

1. The report fulfils three legislative requirements by recommending that council approves the following:

- The treasury management strategy. This sets out how the council's treasury service will support capital investment decisions, and how treasury management operates day to day. It sets out the limitations on treasury management activity through treasury prudential indicators, within which the council's treasury function must operate. It also identifies likely treasury management activities for the forthcoming financial year. The strategy is included as appendix A to the report.

- The annual investment strategy. This sets out the council's criteria for selecting investment counterparties and limiting exposure to the risk of loss on its investments. This strategy is in accordance with department of communities and local government investment guidance, and forms part of the treasury management strategy (appendix A).

- The prudential indicators for expected treasury management activities, as required by the Chartered Institute of Public Finance and Accountancy (CIPFA) Prudential Code for capital finance in local authorities. These are shown in annexe 2.

Strategic objectives

2. A treasury management strategy helps us to meet our strategic objective of managing our business effectively. Managing the finances of the authority in accordance with the treasury management strategy will help to ensure that resources are available to meet the council's other strategic objectives.

Background

3. The council's treasury activities are strictly regulated by legislation. This requires each local authority to establish and maintain comprehensive objectives, policies and practices, strategies and reporting arrangements for the effective management and control of its treasury management activities. These documents provide the parameters within which officers will operate the council's treasury management function.

4. The CIPFA Prudential code and CIPFA Treasury Management Code of Practice were revised in December 2009. The revised codes increased members' responsibility, including greater member scrutiny of the treasury policies, increased member training and awareness and the provision of information to members on a more frequent basis.

5. The council's treasury management policy statement incorporates specific Treasury Management Practices (TMPs), which set out how it will manage the the council will seek to achieve the policies and objectives and prescribe how treasury activities are controlled and managed.

6. The current TMPs were adopted on 25 April 2002, and adopted the revised code. This requires that a treasury management strategy is approved by council prior to the beginning of each financial year.

7. The treasury management strategy sets out the council's strategy for borrowing and its annual investment strategy. It also incorporates the prudential indicators

for the next four years; these demonstrate that the council's capital investment plans are affordable, prudent and sustainable.

8. Sector Treasury Services Limited provide specialist treasury management advice to the council. Its advice has been considered in the preparation of the treasury management strategy.

Recommended changes to the treasury management strategy

9. Council approved the 2010/11 treasury management strategy on 19 February 2010. The proposed strategy for 2011/12 includes the changes detailed below, which cabinet is asked to recommend to council:

   - To provide for a separate category of investment type for pooled bond funds.

10. This change is proposed to provide the facility to include bond funds as a category of investment, so that they could be invested in if required. These type of funds have a maximum security rating (i.e. AAA), and invest in only highly rated organistions. The strategy will continue to adhere to the investment fundamentals, i.e. giving priority first to security, then to liquidity and finally yield.

Financial implications

11. The council's investments have historically been in excess of £100 million, and over the last ten years have generated on average between £5 million and £6 million of investment income per annum. In the last two years investment income has reduced significantly due to the low interest rates which have persisted since the financial crisis in 2008/2009. In the medium term interest rates are expected to rise. The amounts available for investment are projected to fall to £87 million by 2015/16.

12. The table below shows the falls in the amounts available for investment, together with the investment income estimated to be achieved, for the period to 2015/16.

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
	£000	£000	£000	£000	£000	£000
Average balances	93,414	88,482	87,055	87,193	87,232	86,842
Working capital	15,000	15,000	15,000	15,000	15,000	15,000
Average balances	**108,414**	**103,482**	**102,055**	**102,193**	**102,232**	**101,842**
Forecast average interest rate	1.9%	1.8%	2.0%	3.0%	3.0%	3.0%
Interest earned	**2,101**	**1,863**	**2,041**	**3,066**	**3,067**	**3,055**
Less - non distributable amount (see note)	(378)	(250)	(250)	(250)	(250)	(250)
Distributable amount	**1,723**	**1,613**	**1,791**	**2,816**	**2,817**	**2,805**

Note: the non-distributable amount in the table refers to dividends received on equities, which are reinvested in further equities. The distributable amount is the amount available to fund revenue expenditure and capital grants

13. The 2011/12 budget setting report takes into account the latest projections of anticipated investment income.

Legal implications

14. The council must approve the treasury management strategy and annual investment strategy in accordance with the Local Government Act 2003, the CIPFA Code of Practice for Treasury Management in the Public Services, the ODPM Local Government Investment Guidance under Section 15(1) (a) Local Government Act 2003 and CIPFA Prudential code for capital finance.

15. All the council's investments are, and will continue to be, within its legal powers.

Conclusion

16. This report provides details of the proposed treasury management strategy and the annual investment strategy for 2011/12, and recommends the treasury management strategy and prudential indicators to council. These documents provide the parameters within which officers will operate the council's treasury management function

Background papers

- Chartered Institute of Public Finance and Accounting (CIPFA) Treasury Management in the Public Services Code of Practice and Cross Sectoral Guidance Notes
- CIPFA Prudential code for capital finance in local authorities
- Various committee reports, principally:-

  I. Treasury management policy statement, treasury management practices (cabinet 7 March 2002)
  II. Recommendation of amendment to delegated authority (council 28 October 2004)
  III. Treasury management investment strategy (cabinet 8 February 2010, council 19 February 2010)

Appendices

Appendix A	Treasury management strategy 2011/12 – 2014/15	
	Annexe 1	Investment category limits
	Annexe 1a	Current investments
	Annexe 2	Treasury management prudential indicators
	Annexe 3	Treasury management practice (TMP) 1 – credit and counterparty risk management.
	Annexe 4	Security, liquidity and yield benchmarking

Draft treasury management strategy

(Incorporating the annual investment strategy)

Background information

1. The 2010/11 treasury management strategy was approved by council on 19 February 2010. The treasury management service is an important part of the overall financial management of the council's affairs. The service covers the borrowing and investment activities of the council and the management of associated risks, whilst the prudential indicators consider the affordability and impact of capital expenditure decisions. The treasury management service considers the future need to fund capital expenditure and the management of the movements in cash flows. The income generated from investments is significant to the council and is used to support costs of services and capital expenditure.

2. The council's treasury activities are strictly regulated by statutory requirements and a professional code of practice.
   This strategy statement has been produced in accordance with:

   - The Local Government Act 2003 and the CIPFA Prudential Code;
   - The latest Code of Practice on Treasury Management published by the Chartered Institute of Public Finance and Accountancy ("the code");
   - The treasury management policy and council financial regulations, which require a treasury management strategy to be reported to council for the forthcoming year.
   - The statutory guidance on local government investments, which requires an annual investment strategy to be produced outlining the expected treasury activity.

   A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced after the year-end to report on actual activity for the year. A new requirement of the code of practice is that there is a mid-year monitoring report, the first of which covered the period 1 April 2010 to 30 September 2010.

3. It is a statutory duty for the council to determine and keep under review how much it can afford to borrow. The amount determined is called the "affordable borrowing limit". This is to ensure that total capital expenditure remains within sustainable limits and, in particular, that the impact upon its future council tax levels is 'acceptable'. The affordable borrowing limit will be reviewed at regular intervals by officers as part of the monitoring process for prudential indicators.

4. The prudential indicators are an integral part of the treasury management strategy. They are approved for a four-year period as part of the annual budget process, and are shown in annexe 2.

Treasury management advisers

5. The council has used Butlers as its treasury management consultants. Butlers were a business division of ICAP Securities Limited. On 4 October 2010, ICAP plc announced its decision to transfer the services provided by Butlers to Sector Treasury Services Limited following a strategic review of the provision of treasury consultancy services.

6. Sector is a subsidiary of the Capita Group plc and is a leading independent provider treasury advisory services to the public sector. From 25 October 2010 the council's contract with Butlers was assigned to Sector in its entirety. Sector will continue to perform and execute the obligations under the contract, which will formally terminate on the contract renewal date, July 2011. The majority of Butlers' staff transferred to Sector on 25 October 2010 and we have therefore not experienced a disruption to the service provided. Whilst the advisors provide support to the internal treasury function, the final decision on treasury matters remains with the council.

7. Sector's services include the provision of credit rating information, strategic advice including a review of the investment and borrowing strategies and policy documents, advice to assist the council to formulate a view on interest rates, performance indicators and fund management performance monitoring.

Current investment portfolio

8. The council's investment portfolio has averaged at approximately £105 million through 2010. The majority of the investment portfolio is held in cash investments of less than one year in maturity and is therefore exposed to short-term interest rate movements.

9. The objective of the 2010/11 strategy was to keep investments short–term due to the financial uncertainty in the financial markets. It would not have been prudent to re-invest maturing deposits for long periods. In 2010/11 the majority of investments have therefore been placed for less than one year.

10. The maturity period of investments has been lengthened by a few longer dated deposits where rates and the security of the counterparty are good. The council has reduced its exposure to corporate bonds in the year by not replacing bonds at redemption. In addition, equities have been disposed of in year, as opportunities have arisen in the financial markets.

11. Total investment income is predicted to fluctuate between a range of £2.1 million in 2010/11 to £3.8 million in 2015/16 as the council finances the capital programme, and interest rates continue to remain low. There is uncertainty over these figures due to the current economic climate, which remains volatile due to concerns in the eurozone. Looking ahead the forecasts are very difficult to predict and will continue to be linked to inflation, sovereign debt and economic growth.

12. The council's investment position as at 31 December 2010 is shown in table 1 below. It shows that roughly seven per cent (of the entire investment portfolio) is held on call or in notice accounts, and that 78 per cent of the total investment portfolio is held in cash deposits.

Table 1: maturity structure of investments (as at 31 December 2010):		
Cash deposits:	**Total £000**	**%**
Call	5,007	4%
30 day notice	3,925	3%
Up to 1 month	2,500	2%
1 Month	2,500	2%
2-3 Month	14,000	12%
3-4 Month	4,500	4%
4-6 Month	4,500	4%
6-12 Month	36,500	32%
1 -2 Year	9,000	8%
2-3 Year	5,000	4%
3-4 Year	-	0%
4-5 Year	-	0%
KSF (see below)	1,106	1%
Total cash deposits	**88,538**	**78%**
Equities	12,324	11%
Corporate bonds	6,125	5%
Money market funds	6,394	6%
	113,381	**100%**

(maturity periods refer to time remaining to end of term).

Icelandic banks – Kaupthing Singer & Friedlander (KSF)

13. The council invested £2.5 million with the failed Icelandic bank Kaupthing Singer & Friedlander (KSF), which is under administration. To date, the council has received £1.4 million in respect of its claim for £2.6 million (£2.5 million investment plus interest) deposited with KSF. Table 1 above includes the remaining amount of the claim.

14. The investment placed in July 2007 was due for repayment on 12 December 2008. As a wholesale depositor the council is treated as an unsecured creditor of KSF in the administration process, and ranks equally with all other unsecured creditors.

15. The administrator's intend to make further payments at regular intervals. The next report is scheduled for April 2011. The latest creditors report now indicates that the estimated total amount to be recovered should be in the range of 75p to 84p in the £. In total terms this would mean receiving between £1,950,000 and £2,184,000 of the claim. This is an increase from the previous report which indicated 75p in the £.

Investment performance for the year to 31.12.2010

16. The council's budgeted investment return for 2010/11 is £1.845m, and the actual interest earned to date is shown in table 1a. The total interest is split between interest that is distributable and interest earned on equities which is non-distributable. The distributable amount of interest is lower than the original forecast reported in the MTFS.

	Interest earned Apr - Dec 2010				
Investment type	Annual budget	Actual to 31.12.10	Forecast Jan - Mar 11	Forecast 2010/11	Variation
	£000	£000	£000	£000	£000
Call accounts	120	76	18	94	(26)
cash deposits < 1 yr	990	425	100	525	(465)
Cash deposits > 1 yr	110	296	209	505	395
MMF	32	19	10	29	(3)
Corporate bonds	583	440	120	560	(23)
Transferred debt	10	0	10	10	0
Total distributable interest	**1,845**	**1,256**	**467**	**1,723**	**(122)**
Non distributable interest -equities	0	193	185	378	378
Total interest	**1,845**	**1,449**	**652**	**2,101**	**256**

* Interest on equities not included in annual budget as nondistributable

17. The portfolio has outperformed the benchmarks for the year to date. Internally managed investments have exceeded the benchmark by 0.7 per cent. The following table highlights the actual returns achieved to the 31 December 2010.

Table 1b: investment returns achieved against benchmark

	Benchmark return	Actual return	Growth (below)/above benchmark	Benchmarks
	%	%	%	
Bank & building society deposits - non-managed	0.60%	1.30%	0.70%	3 Month LIBID
Equities	5.22%	7.69%	2.47%	FTSE all shares index
Corporate bonds	0.50%	7.59%	7.09%	BoE base rate

Economic conditions and interest rate forecasts

18. In order to put the investment strategy into context it is necessary to appreciate the external factors in the financial markets and the current interest rate forecasts.

19. Lots of uncertainty continues throughout the global economy, currently focused on the eurozone. Portugal's government needs to borrow around 20 billion euros from the markets this year. Like Greece and Ireland, Portugal represents a tiny fraction of the eurozone economy. However Portugal's main problem is that the country has weak prospects for growth. Should Portugal require a bailout, it becomes much

more difficult to predict how many other countries within the eurozone will follow, as many others have a similar problem of lack of confidence in future growth prospects.

20. Inflation is increasing in the eurozone. During 2010 severe weather in some of the world's biggest food exporting countries has damaged supplies, pushing food prices almost 20 per cent higher than a year ago. In December the wholesale cost of food reached its highest monthly figure on records. World commodity prices are now almost at levels in 2008, which saw food riots break out around the developing world, and rising inflation in the UK and other big western economies. Oil prices have also reached their highest level in two years.

21. In the UK public finances have yet to improve. Government borrowing is £6 billion higher than the previous year in November. It is uncertain if the government will be able to meet its borrowing forecast of £149 billion this year. House prices continue to fall, and unemployment in the UK increased to 2.5 million at the end of October 2010.

22. Consumer expenditure is the most important factor in sustaining growth. This will continue to be affected by job uncertainty and lack of access to credit. Consumer spending power is being constrained, because pay is not keeping up with inflation. Consumers are also faced with record petrol prices, the increase in VAT in January from 17.5 per cent to 20 per cent and price rises for gas and electricity have also added to the rise in costs of many goods and services. Economic recovery will remain weak without continued growth in consumer spending.

23. As expected, the Bank of England's Monetary Policy Committee (MPC) kept rates on hold at the meeting on 13 January 2011. Strong inflation and increased growth data were the key reasons why the MPC have not sanctioned further Quantatitive Easing (QE). The most recent official figures show that although the UK economy grew by 0.7 per cent in the period July – September 2010, the growth in the fourth quarter decreased by 0.5 per cent, with the largest declines in the business services and finance sectors.

24. Consumer Price Index (CPI) inflation rose to 3.7 per cent in December. It has been above the two per cent target for more than 12 months and it is expected to rise to above four per cent. The price of goods leaving UK factories rose faster than expected in December 2010, as the cost of wheat and sugar pushed up the price of ingredients for food manufacturers and the price of metal, oil and chemicals shot up for other factories.

25. The gilt market, where the government goes to raise money by selling bonds, immediately reacted with yields rising. These yields are the closest the city comes to a forecast for what interest rates will be in the future. The yield on a two-year Treasury gilt has increased by 0.06 per cent to 1.37 per cent. Analysts suggest that the gilt market is now pricing in an interest rate rise in June 2011. The MPC have two options, either keep rates low to aid economic recovery or to raise rates to try and cool inflation.

26. At the time of writing this report, short term rates are expected to remain at 0.5 per cent until the later part of 2011, although the MPC may have to raise the bank rate earlier than September in order to reinforce its credibility. This position may change quite quickly as inflation data is released during the next few months.

27. Medium term forecasts indicate a quarter point rise in the bank base rate by December 2011, with further quarter point increases during 2012, 2013 and 2014. Medium term rate forecasts currently expect the bank base rate to be four per cent by 2014/15. The interest forecasts beyond one year may change quite significantly as the financial markets react to world events.

28. Sector treasury advisors assist the council in formulating a view on interest rates. Table 2 below shows Sectors' forecast of the expected movement in interest rates, in the short term, while table 3 shows the medium term forecast.

Table 2: interest rate forecasts - 2011/12

			Money market rates %			PWLB rates*	
Year	**End period**	**BoE base rate**	**3mth**	**6mth**	**12mth**	**5yr**	**25yr**
2011	Jan	0.50	0.6	0.9	1.4	3.4	5.3
	Mar	0.50	0.6	0.9	1.4	3.3	5.2
	Jun	0.50	0.7	1.0	1.5	3.3	5.2
	Sep	0.50	0.8	1.1	1.6	3.4	5.2
	Dec	0.75	1.0	1.2	1.8	3.5	5.3
2012	Mar	1.00	1.3	1.5	2.1	3.6	5.3
	Jun	1.25	1.5	1.8	2.4	3.8	5.4
	Sep	1.50	1.8	2.1	2.7	3.9	5.4

* Borrowing rates.
Source: Sector - January 2011

Table 3: medium-term interest rate forecasts

Annual average	**Bank base rate**	**Money market rates %**		**PWLB rates***		
		3mth	**12mth**	**5yr**	**25yr**	**50yr**
2010/11	0.5	0.7	1.5	2.6	4.6	4.7
2011/12	0.7	0.9	1.8	3.5	5.3	5.3
2012/13	1.7	1.9	2.8	4.0	5.4	5.4
2013/14	3.1	3.3	3.8	4.8	5.6	5.6
2014/15	4.0	4.2	4.5	5.6	5.6	5.8
2015/16	4.0	4.2	4.2	5.3	5.5	5.5

* Borrowing
Source: Sector - January 2011

Borrowing strategy 2011/12 – 2015/16

29. The council is debt free and does not currently need to borrow. The council will continue to take a prudent approach to its debt strategy. It is not expected to enter into any significant borrowing in the medium or long term. The prudential indicators and limits for debt are set out in annexe 2 and provide the scope and flexibility for the council to borrow in the short-term up to a maximum of £5 million, if such a need arose within the cash flow management activities of the authority, for the achievement of its service objectives.

30. The treasury management strategy for the forthcoming year aims to efficiently manage the investment portfolio by reducing the amount of funds held extremely short-term for cash flow purposes and operating with an adequate but not excessive level of working capital. This optimum level is dictated by the accuracy of cash flow forecasts and, although unlikely, it is prudent to set a minimum level for the use of short-term borrowing arrangements or overdraft facilities if the cash flow forecasts prove inaccurate at any point in the year.

31. The head of finance, would in such instances take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above.

Annual investment strategy 2011/12- 2015/16

Background

32. The main principle governing the council's investment criteria is maintaining the security and liquidity of its investments, although the yield or return on the investment will be a consideration, subject to adequate security and liquidity. After this main principle the council will ensure:

- It has sufficient liquidity in its investments. For this purpose it has set out parameters for determining the maximum periods for which funds may prudently be committed. These parameters are summarised in annexe 1, and in the treasury management limits on activity section;

- It maintains a policy covering the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security.

33. The strategy aims to provide a high degree of flexibility to take appropriate lending decisions, with a view to returning the portfolio to a more even spread of maturity periods as and when institutional security and market confidence returns. This approach should provide a more even and predictable investment return in the medium term.

Investment types

34. The types of investment that the council can use are detailed below. These are categorised under the headings of specified and non-specified in accordance with the statutory guidance, further details of which are set out in annexe 3. The financial limits applied to these investments are set out under each specific investment type and are also summarised in annexe 1 with the counterparty selection criteria.

Specified investment instruments (maximum period 1 year)

- Bank and building society cash deposits
- Deposits with UK local authorities
- UK Government – DMADF, treasury stock (Gilts) with less than one year to maturity
- Money Market Funds (MMF) (AAA rated)

- Pooled Bond funds (AAAf rated)
- Debt Management Agency Deposit Facility (DMADF)
- Certificates of deposits with banks and building societies

Non-specified investment instruments (beyond 1 year)

- Bank and building society cash deposits up to 5 years
- Deposits with UK local authorities up to 5 years
- Corporate bonds
- Pooled property or bond funds
- UK pooled equity funds
- UK treasury stock (Gilts) up to 10 years
- Supranational bonds up to 10 years

Cash deposits

35. The majority of the council's investments are held in cash deposits. These can be made with banks or building societies that meet the credit rating criteria detailed in annexe 1. Any non-rated subsidiary of a credit rated institution can be included as an investment category subject to individual assessment of the relationship between themselves and the parent bank. Where institutions are part of a banking group then the maximum lending criteria will be shared between the group companies. Limits on amounts for each counterparty are determined by credit rating and maturity period.

36. The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies that are credit rated. The council may use such building societies which have a minimum asset size of £500 million, but will restrict these types of investments to six months. Unrated building societies with a minimum asset size of £1 billion will be restricted to investments under nine months duration. However, with the current uncertainty in global financial markets officers are not anticipating making any investments with an unrated counterparty until the financial outlook stabilises.

37. Cash deposits can be made with UK local authorities up to a period of five years and a maximum of £15m per authority. Local authorities do not require a credit rating, and are classed as a low risk counterparty due to their funding and income streams.

Gilts

38. Gilts (or 'gilt-edged stocks') are bonds issued by the government which pay a fixed rate of interest twice a year. They are considered safe investments as the government is unlikely to default on the interest payments. If held to maturity they will return their issue value; if sold before their redemption date the price realised will fluctuate with market conditions. Gilts are bought and sold on the stock market where their price can go up or down. The strategy permits investments of up to £15 million in gilts. The council does not currently hold any gilts, as market conditions have not presented an opportune time to enter the gilt market. This is reviewed frequently.

Money market funds (MMFs)

39. MMFs are commercially run, pooled investments. They work rather like unit trusts, but whereas the latter are based upon shares in companies, MMFs rely on loans to companies. As their pooled funds have a high total value better rates of returns can be obtained. Legislation allows authorities to access only those MMFs with the highest possible credit rating (AAA).

40. The maximum limit to be invested in this type of instrument is £20 million. Access and liquidity of these instruments are extremely flexible, as they operate on a similar basis to call deposit accounts in that the funds can be placed or withdrawn with a minimum amount of notice, but tend to achieve better rates than short-term cash deposits placed in the market over similar periods, particularly in a declining or flat interest rate environment.

Government's debt management account deposit facility (DMADF)

41. The DMADF is a deposit account with the Government. The rates are very low, however this is offset by the increased security and facility to improve the portfolio's spread of investments. A maximum limit of 100 per cent of the portfolio is set in the strategy for this facility. The account is only used when it is not possible, or it is outside the council's risk tolerance to place monies elsewhere.

Certificates of deposit

42. Certificates of deposit are a type of bonds issued by banks. They are classified as non- specified investments. Certificates of deposit are bought and sold on the stock market where their price can go up or down. If held to maturity they will return their issue value; if sold before their redemption date the price realised will fluctuate with market conditions. The council would only consider the use of these investments through a fund manager as part of balanced fund portfolio.

Corporate bonds

43. Corporate bonds are issued by companies as a way of raising money to invest in their business. They have 'par' or nominal value' (usually £100), which is the amount that will be returned to the investor on a stated future date (the 'redemption date'). They also pay a stated interest rate each year, usually fixed. Corporate bonds are bought and sold on the stock market and their price can go up or down.

44. The council continues to maintain holdings of corporate bonds previously acquired, on the basis that returns on these securities over their remaining lives should out perform the current bond markets and returns from fund management, given the view that interest rates and yields are forecast to remain low in the near term. The strategy permits investments of up to £10 million in corporate bonds (measured at the time of purchase). The current value of corporate bonds held is £6.1 million as at 31 December 2010.

45. The remaining bonds are providing an excellent rate of return. However, two bonds are due to mature in 2011 and as bond prices tend toward par as they approach maturity, there will be an optimum point at which each bond provides the best return versus the deterioration in capital value. Sector has reviewed the council's current holdings and the analysis shows that in the current interest rate environment they

should be held until maturity. The review also explores the possibility of lengthening the maturity profile to maintain the higher rates of return. This will be reviewed by the head of finance.

Property

46. The council is also able to purchase property as an investment, however this is a specialist area and it is necessary to seek external advice on how the council could best diversify its investments by the inclusion of property.

47. The uncertainty in the property market has meant that the council is not currently considering further investment in property, however further research will be undertaken with the assistance of the council's current property advisors and treasury advisors (Sector) to assess which products may be suitable should there be an upturn in the market. The treasury management strategy allows for an investment of up to £20 million in direct property holdings (as measured at the time of purchase).

48. The council currently retain properties for investment purposes. As at the end of March 2010, the latest period for which audited figures are available, these had an aggregate book value of £15.9 million.

Bond funds

49. These are pooled investment funds which have been developed to provide investors with access to the bond market, spreading the risk of direct bond holdings by giving access to a portfolio of mixed bonds ranging from UK Gilts, supranational bonds, other government guaranteed issues and corporate bonds of both banks and corporate organisations. Very much like MMFs they are strictly regulated and those that achieve AAAf credit rating must maintain liquidity. Funds can be accessed quickly if required. The maximum limit to be invested in this type of instrument is £5 million.

Equities

50. 'Equity' is an investment in the share capital of a publicly quoted company. Equity is the risk-bearing part of the company's capital and contrasts with debt capital which is usually secured in some way, and which has priority over shareholders if the company becomes insolvent and its assets are distributed.

51. For most companies there are two types of equity: ordinary shares, which have voting rights, and preference shares, which do not. Owners of preference shares rank ahead of ordinary shareholders in a liquidation.

52. The council's investments in equities are liquid investments, which mean they could be sold at any time, from which an investment gain (or loss) could accrue to the council.

53. The council continues to maintain its current equity holdings, on the basis that that although the returns have fluctuated these are intended to be held long-term and they also provide diversity to the portfolio. The strategy permits investments of up to £10 million in equities (measured at the time of purchase).

Supranational bonds

54. Supranational bonds fall into two main categories – multilateral development bank bonds, or those offered by a financial institution that is guaranteed by the UK Government. The security of interest and principal on maturity is on a par with UK Government bonds and these bonds usually provide returns above equivalent gilt edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity. The treasury management strategy permits investment of up to £15 million in supranational bonds (measured at the time of purchase). The council currently does not hold these investments, although they offer excellent security and liquidity. This is reviewed periodically. Given the current low yields it would not be the best time to purchase these to hold for the long term.

Approach to investing

55. Whilst the current market uncertainties remain the council will aim to keep investments relatively short term, but also continue to look for opportunities to fix lending for longer periods with highly rated institutions, and increase the weighted average maturity of the portfolio. A full list of investments held as at 31 December 2010, is shown in annexe 1a.

56. Should market conditions deteriorate suddenly to the extent that the council is unable to place money with institutions with the necessary credit rating, it will make use of the UK Government deposit account (DMADF).

57. The property investment and corporate bond holdings will be kept under continuous review to identify if further investments should be placed in these categories.

58. Money market funds are used for security and liquidity, and to spread portfolio risk. The council will monitor our exposure to these funds in order to manage our security risk.

59. There will be no further investment in equities at this time. However, the investment held will be kept under review.

60. Bond funds can be used to diversify the portfolio, whilst maintaining liquidity and security. These will be considered and reviewed for investment.

Counterparty selection

61. Treasury management risk is the risk of loss of capital to the council. To minimise this risk, the credit rating of counterparties is a significant factor when considering who to lend to and this is regularly monitored. The council receives credit rating updates from Sector as and when ratings change. Ratings may be downgraded after an investment has been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria, or those on the minimum criteria placed on negative credit watch by the rating agencies (Standard & Poors, Fitch and Moodys), will be removed from the list, and new counter parties which meet the criteria will be added to the list.

62. The criteria proposed for choosing counterparties provide a sound approach to investment in “normal” market circumstances. Whilst members are asked to approve

this base criteria in annexe 1, under the exceptional current market conditions the head of finance may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval. These restrictions will remain in place until the banking system returns to “normal” conditions. Similarly the time periods for investments will be restricted. Examples of these restrictions would be the greater use of the Debt Management Deposit Account Facility (DMADF – a Government body which accepts local authority deposits), money market funds, guaranteed deposit facilities and strongly rated institutions offered support by the UK Government.

63. The primary principle governing the council’s investment criteria is the security of investments, although liquidity and yield are also key considerations. The council will ensure:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitor their security. This is set out in TMP1 – credit and counter-party risk management (annexe 3);

- It maintains sufficient liquidity in its investments to cover cash flow. It will set out procedures to determine maximum periods for which funds can be invested.

64. The head of finance will ensure a counterparty list (a list of named institutions) is maintained in compliance with the recommended credit rating criteria (annexe 1) and will revise the criteria and submit any changes to the credit rating criteria to council for approval as necessary. The counterparty list will comply with the criteria detailed below. This criteria is separate to that set out in TMP1 as it provides an overall list of counterparties which the council may use for investing.

65. The rating criteria uses the **lowest common denominator** (LCD) method of selecting counterparties and applying limits. This means that the application of the council’s minimum criteria will apply to the lowest available rating. For instance, if an institution is rated by two agencies and under one agency the counterparty meets the council’s criteria, but under the other does not, then the institution will fall outside the lending criteria. This is in compliance with the CIPFA Treasury Management Panel recommendation in March 2009. The council will lend to institutions that meet the following criteria:

1.Banks good credit quality – the council will only use banks which are:

a) UK banks; and / or
b) non-UK and domiciled in a country which has a minimum sovereign long term rating of AAA

They must also have as a minimum, the following Fitch, Moody’s and Standard and Poors credit ratings (where rated):

- Short term – F1/ P1 /A1
- Long term – A /A3
- Individual / financial strength – C
- Support – 3 (Fitch only)

2. Bank guaranteed with sovereign support – the council will use banks whose ratings fall below the criteria set (annexe 1) if all of the following conditions are met:

a) wholesale deposits in the bank are covered by a government guarantee;
b) the government providing the guarantee is rated AAA; and
c) the council's investments with the bank are limited to amounts and maturity terms within the terms of the guarantee.

3. Banks - eligible institutions – the organisation is an eligible institution for the HM Credit Guarantee Scheme effective from 13 October 2008, and meets the short / long term ratings required above.

4. Banks - other - The council's own banker for transactional purposes if the bank falls below the above criteria, although in such a case balances will be kept to a minimum.

5. Bank subsidiary and treasury operations - the council will use these where the parent bank meets the requirements above and provides 100 per cent cover of the UK subsidiaries debt should it cease trading for any reason.

6. Building societies – the council will use societies which;

a) meet the ratings for banks above; or are both:
b) An eligible institution; and
c) Have assets in excess of £500 million.

7.Money market funds – the council will use AAA rated money market funds

8. Bond funds – the council will use bond funds which have a AAAf credit rating.

Country and sector considerations

66. Due care will be taken to consider the country, group and sector exposure of the council's investments. In part the country selection will be chosen by the rating of the sovereign state in 61.1 above. Sector limits will be monitored and reviewed regularly.

Additional information to supplement credit ratings

67. The council is required under the code to supplement credit rating information with operational market information such as credit default swaps (CDS), negative watches and out looks, which are to be applied when comparing the security of counterparties. The current market instability dictates that operationally the counterparty list is frequently reviewed and changed if necessary.

68. A reduced counterparty list is currently in operation. Where it is felt the council would benefit from utilising government guarantees provided by countries with an AAA rating, the council will lend to institutions covered by such guarantees. Any decision to lend in this way will be subject to consultation with and the agreement of the cabinet member responsible for finance.

Fund managers

69. The investment strategy provides the ability to invest an element of the portfolio from cash deposits to a fund manager. Fund managers can invest in a variety of investment types which such as cash deposits, gilts and certificates of deposits. These types of funds can extend the spread of investment portfolio, access highly rated institutions and capitalise upon opportunities to improve returns in a low interest rate environment, whilst maintaining liquidity. This type of fund is periodically reviewed to assess when might be a suitable time to consider investing. Whilst the council operates a restrict list in terms of counterparty and maturity periods, the benefits to be gained from them are reduced.

70. The previous fund management contract with Tradition UK Limited (TUK) expired in November 2008. However, economic and market conditions during 2010/11 meant that the council operated with an extremely restricted lending list, and with short maturity terms. It therefore did not make commercial sense to re-tender the contract at that time. The treasury management strategy allows for a total of up to £20 million portfolio to be placed with a fund manager. This is reviewed annually, and at present it is not evident that the council would benefit from the service of a fund manager due to the market conditions. However, the situation will continue to be reviewed and as market conditions improve there may be a greater benefit to be gained from the service of a fund manager. At that time, the contract will be re-tendered.

Treasury management limits on activity

71. The Local Government Act 2003 requires the council to adopt the CIPFA Prudential Code and set a number of prudential indicators as part of the budget setting process. They set the parameters within which we manage the overall capital investment and treasury management functions. Within this overall prudential framework there is a clear impact on the council’s treasury management activity, either through borrowing or investment activity.

72. There are four treasury activity limits. The purpose of these are to contain the activity of the treasury function within these limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. The limits are set out in table 4 below.

- Upper limits on fixed interest rate exposure – this covers a maximum limit on fixed interest rates.
- Upper limits on variable interest rate exposure – this identifies a maximum limit for variable interest rates based upon the debt position net of investments.
- Maturity structures of borrowing – these limits are set to reduce any exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.
- Total principal funds invested for greater than 364 days – these limits are set to manage the council’s liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

Cabinet is asked to recommend council to approve the limits:

Table 4: treasury management limits on activity

Investments	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m	2014/15 Estimate £m
Interest rate exposures				
Limits on fixed interest rates	100	90	80	80
Limits on variable interest rates	30	30	30	30
Maximum principal sums invested > 364 days				
Upper Limit for principal sums invested > 364 days	50	45	40	40
Limit to be placed on investments to maturity:				
1 - 2 years	70	70	70	70
2 - 5 years	50	50	50	50
5 years +	50	50	50	50
Debt				
Interest rate exposures				
Maximum fixed rate borrowing	10	10	10	10
Maximum variable rate borrowing	10	10	10	10

73. The total portfolio is also limited further by percentage limits which apply for the categories of investment type. This is shown in annexe 1 and approval is also required for this.

74. In the normal course of the council's cash flow operations it is expected that both specified and non-specified investments will be utilised for the control of liquidity as both categories allow for short term investments. The use of longer term instruments (greater than one year from inception to repayment) will fall in the non-specified investment category. These instruments will only be used where the council's liquidity requirements are safeguarded. This will also be limited by the longer term investment limits.

Risk and performance benchmarks

75. A requirement of the code is that security and liquidity benchmarks are considered and approved. This is in addition to yield benchmarks which are used to assess performance.

76. The benchmarks are targets (not limits) so may be breached depending on the movement in interest rates and counterparty criteria. Their purpose is to allow officers to monitor the current trend position and amend the operational strategy depending on any changes. Any breach of the benchmarks will be reported, with an explanation in the mid year or annual report to audit and corporate governance committee. Detailed information for the assessment of risk is shown in annexe 4. In summary:

77. **Security** – the council's maximum security risk benchmark for the current portfolio, when compared to the historic default tables is percent historic risk of default when compared to the whole portfolio. The security benchmark for each individual year is:

	1 Year	2 Years	3 Years	4 Years	5 Years
Maximum	0.03%	0.15%	0.30%	0.44%	0.65%

Note : This is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

78. **Liquidity** – the council will aim to maintain:

- Bank overdraft £0.5 million
- Liquid short term deposits of at least £10 million available with a weeks notice
- Weighted average life benchmark is expected to be 0.5 years with a maximum of three years.

79. **Yield** – the councils benchmarks for the return on investments is for interest returns to exceed the three month London Interbank Bid Rate (this is the rate a bank is willing to pay for funds in the international interbank market). This rate is chosen, as it is historically a good indication of average short term money market rates.

80. The code requires the council to set performance indicators to assess the performance of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. To assess and monitor the council's investment performance, the following will be used as a benchmark for each investment instrument, however security of investments will always take precedence over returns:

- cash deposits - to achieve a minimum of three month LIBID
- external fund managers – a minimum of three month LIBID rate
- gilts : to outperform the FTSE Actuaries Government All Stocks Index by 0.75 per cent per annum over rolling three year periods, and not to under perform the FTSE Actuaries Government All Stocks Index by more than two percent over any rolling twelve month period
- corporate bonds - a minimum cash and redemption yield of the Bank of England base rate
- equities- at least match the FTSE All Share Index
- debt - average rate of borrowing for the year compared to average available.

81. Performance will be reported to cabinet, council and audit and corporate governance committee in the treasury management mid-year and outturn reports.

Other prudential indicators

82. In addition to the above limits and benchmarks, the council must also agree to certain other prudential indicators, concerning debt, and the adoption of the code. These are detailed in annexe 3.

Member and officer training

83. The requirement for increased member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for members and officers. In compliance with the revised code, the council has started to address this important issue by providing initial member training on treasury management.

Summary

84. Prior to the beginning of each financial year the council must approve the treasury management strategy. The strategy sets the parameters within which officers can invest the council's surplus fund.

85. This strategy provides a commentary on the current financial climate and sets out the council's lending strategy in response to this.

Investment category limits proposed for 2011/12

The rating critiera specified requires the lowest common denominator method of applying these limits:
ie: If an institution fails to meet the lending criteria of one agency rating it will fall outside the lending criteria.

	FITCH				MOODY'S			STANDARD & POORS		Asset	Govt guarantee for wholesale deposits	Max limit per	Time
Specified instrument:	**S/term**	**L/term**	**Indiv.**	**Support**	**S/term**	**L/term**	**FSR**	**S/term**	**L/term**	**backing £m**		**counterparty £m**	**limit**
Bank / BS cash deposits(1)	F1	A	C	3	P1	A3	C	A-1		>£1bn		£15m	1 year
Bank / BS cash deposits(2)											Govt rating => AAA from all 3 agencies	£15m	Term of guarantee
Money Market Fund	AAA				AAA			AAA		n/a		£5m	n/a
DMADF - cash deposits	n/a				n/a			n/a		n/a		no limit	n/a
UK govt or LA												£15m	I year
Non-specified instrument:													
Unrated building society	n/a				n/a			n/a		>£1bn		£15m	9 months
Unrated building society	n/a				n/a			n/a		>£500m		£10m	6 months
Bond fund								AAA		n/a		£5m	n/a
Long term bank / B soc	F1	A	C	3	P1	A3	C	A1	A	-		£15m	2 years
Long term bank / B soc	F1	A+	B	2	P1	Aa3	B	A1	A+	-		£15m	3years
Long term bank / B soc	F1	AA-	B	2	P1	Aa3	B	A1	AA-	-		£15m	4 years
Long term bank / B soc	F1	AA+	A	1	P1	Aa1	B+	A-1+	AA	-		£15m	5 years
Bank subsidiary	*				*			*		*		£15m	*
Bank treasury dept	As per parent bank											£15m	
UK equities												£10m	No Limit
UK LA												£15m	5 years
UK government - gilts												£15m	10yr

* Bank subsidiary limits will depend on the relationship between themselves and their parent bank. A subsidiary will only be included on the counterparty list if some form of guarantee exists between it and the parent entity.

Investment portfolio limits:

	£m
Upper limit for total principal sums invested over 364 days (per maturity date)	90

Investments held at 31 December 2010

Start Date	Counterparty	Principal	Maturity Date	Rate	Country	Sector Limits	Current Long Term Rating
A	B	C	D	E	F	G	H
03/01/2011	Santander UK Plc	£2,757,000	04/01/2011	0.80%	UK	Banks - UK - Call Accounts	AA-
03/01/2011	Santander UK Plc	£2,250,000	02/02/2011	0.90%	UK	Banks - UK - Call Accounts	AA-
03/01/2011	Royal Bank of Scotland	£3,925,282	04/01/2011	0.85%	UK	Banks - UK - Call Accounts	AA-
03/01/2011	Goldman Sachs	£255,000	04/01/2011	0.50%	UK	MMF	AAA
03/01/2011	Henderson	£5,000,000	04/01/2011	0.60%	UK	MMF	AAA
03/01/2011	Blackrock	£1,139,000	04/01/2011	0.50%	UK	MMF	AAA
05/07/2001	Lloyds TSB Bank	£781,275	17/10/2011		UK	Corporate Bonds	AA-
04/10/2001	Lloyds TSB Bank	£1,006,150	02/01/2011		UK	Corporate Bonds	AA-
26/03/2002	Royal Bank of Scotland	£1,702,725	22/06/2015		UK	Corporate Bonds	AA-
20/03/2003	Halifax	£2,317,300	17/01/2014		UK	Corporate Bonds	AA-
15/04/2003	Santander UK Plc	£347,774	04/01/2017		UK	Corporate Bonds	AA-
01/04/2004	L&G Equities	£12,324,017	04/01/2011		UK	Other	NONE
02/07/2010	Clydesdale Bank	£2,500,000	04/01/2011	1.06%	UK	Banks - UK	AA-
06/10/2010	Bank of Scotland Plc	£2,500,000	01/02/2011	1.08%	UK	Banks - UK	BBB-
06/10/2010	Saffron Walden Herts & Essex Building Society	£2,000,000	07/02/2011	1.00%	UK	Building Societies - Term	NONE
06/10/2010	Kent Reliance Building Society	£2,000,000	07/02/2011	1.00%	UK	Building Societies - Term	NONE
12/02/2010	Barclays Bank	£2,000,000	14/02/2011	1.35%	UK	Banks - UK	AA-
12/02/2010	Santander UK Plc	£2,000,000	14/02/2011	1.58%	UK	Banks - UK	AA-
01/09/2010	Coventry Building Society	£2,000,000	15/03/2011	1.01%	UK	Building Societies - Term	A
23/03/2010	Barclays Bank	£2,000,000	23/03/2011	1.30%	UK	Banks - UK	AA-
23/03/2010	Santander UK Plc	£2,000,000	23/03/2011	1.61%	UK	Banks - UK	AA-
15/10/2010	Bank of Scotland Plc	£2,500,000	15/04/2011	1.28%	UK	Banks - UK	BBB-
15/10/2010	Saffron Walden Herts & Essex Building Society	£2,000,000	15/04/2011	1.20%	UK	Building Societies - Term	NONE
10/11/2010	Progressive Building Society	£2,000,000	10/05/2011	1.20%	UK	Building Societies - Term	NONE
10/11/2010	Clydesdale Bank	£2,500,000	27/05/2011	1.05%	UK	Banks - UK	AA-
15/12/2010	Clydesdale Bank	£3,500,000	15/07/2011	1.10%	UK	Banks - UK	AA-
19/07/2010	Lloyds TSB Bank	£5,000,000	19/07/2011	2.10%	UK	Banks - UK	AA-
27/08/2010	Barclays Bank	£2,500,000	30/08/2011	1.65%	UK	Banks - UK	AA-
01/12/2010	Bank of Scotland Plc	£1,000,000	01/09/2011	1.58%	UK	Banks - UK	BBB-
01/12/2010	Progressive Building Society	£2,000,000	01/09/2011	1.50%	UK	Building Societies - Term	NONE
20/09/2010	Santander UK Plc	£5,000,000	20/09/2011	2.00%	UK	Banks - UK	AA-
01/10/2010	Nationwide Building Society	£2,500,000	03/10/2011	1.36%	UK	Building Societies - Term	AA-
04/11/2010	Barclays Bank	£5,000,000	04/11/2011	1.45%	UK	Banks - UK	AA-
04/11/2010	Nationwide Building Society	£2,500,000	04/11/2011	1.34%	UK	Building Societies - Term	AA-
04/11/2010	Yorkshire Building Society	£2,000,000	04/11/2011	1.50%	UK	Building Societies - Term	A-
15/11/2010	Coventry Building Society	£3,500,000	15/11/2011	1.37%	UK	Building Societies - Term	A
02/12/2010	Cater Allen	£2,000,000	02/11/2011	2.50%	UK	Banks - UK	AA-
12/07/2010	Royal Bank of Scotland	£5,000,000	12/07/2012	2.00%	UK	Banks - UK	AA-
03/09/2010	Lloyds TSB Bank	£4,000,000	03/09/2012	2.45%	UK	Banks - UK	AA-
02/12/2010	Royal Bank of Scotland	£5,000,000	02/12/2013	2.82%	UK	Banks - UK	AA-

Prudential indicators

Introduction

The Local Government Act 2003 requires the council to adopt the CIPFA Prudential Code and set a number of prudential indicators as part of the budget setting process. They set the parameters within which we manage the overall capital investment and treasury management functions. Each indicator either summarises the expected capital activity or sets limits upon the activity, and reflects the outcome of the council's underlying capital appraisal systems. Within this overall prudential framework there is a clear impact on the council's treasury management activity, either through borrowing or investment activity.

Debt

The council is debt free and has no borrowing. Therefore some of the indicators are negative and prove difficult to relate to the day to day treasury management activities. This does not mean however that the council should not still monitor its performance against the indicators.

The indicators which set the limits for debt activity are shown in table 1 below:

Table 1: prudential indicators - authorised limit for external debt

	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m	2014/15 Estimate £m
Authorised limit for external debt				
Borrowing	5	5	5	5
Other long term liabilities	5	5	5	5
	10	**10**	**10**	**10**
Operational boundary for external debt				
Borrowing	2	2	2	2
Other long term liabilities	3	3	3	3
	5	**5**	**5**	**5**

The **authorised limit** is the maximum amount that the council may borrow and must be formally approved by council each year. It reflects a level of borrowing which, while not required, could be afforded but not be sustainable. The proposed authorised limit of £10 million is set to provide for any short-term borrowing that could be required temporarily to deliver the Treasury Management Strategy. It is not anticipated that there will be a need to enter into any long-term borrowing, but there may on occasion be a need to borrow sums as part of the routine operation of its financial management.

The **operational boundary** is a limit for the expected maximum external debt the council is likely to require according to probable events and must be formally approved by council each year. This is set below the authorised limit and a figure of £5 million is recommended to allow the flexibility to borrow short-term for cash-flow variations if the need arose within the day to day treasury management activities of the authority.

Members are asked to note that:

- in approving the limits in this report the authorised limit determined for 2010/11 will be the statutory limit determined under section 3(1) of the Local Government Act 2003.
- in the unlikely event that at any time during the year the strategic director with responsibility for finance believes that this limit(s) may be breeched then he is required to report back to council to allow them to consider what action they wish to take.
- The strategic director with responsibility for finance will maintain a system to monitor the level of borrowing against the authorised limit and operational boundary. If there is any likelihood that either of these limits would be breached the strategic director will report back to council to allow them to consider what action they wish to take.

Adoption of the CIFPA Code of Practice for Treasury Management

The council adopted this code on 25 April 2002 and the strategic director for finance confirms that the authority continues to comply with this.

This indicator in respect of treasury management confirms that the council has adopted the CIPFA code of practice for treasury management in public services. This is to provide assurance that treasury management activities are being carried out in line with best practice.

Treasury Management Practice (TMP) 1 – credit and counterparty risk management

The CLG issued Investment Guidance in 2010, and this forms the structure of the council's policy below.

The key aim of the guidance is to maintain the current requirement for councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This council adopted the code on 25 March 2002 and will apply its principles to all investment activity. In accordance with the code, the head of finance has produced its treasury management practices (TMPs). This part, TMP1(5), covering investment counterparty policy requires approval each year.

The key requirements of both the code and the guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of:

- the strategy guidelines for decision making on investments, particularly non-specified investments.
- the principles to be used to determine the maximum periods for which funds can be committed.

In compliance with the above guidance the Annual investment Strategy is now incorporated within the council's treasury management strategy and includes the following:

- specified investments: these are high security, i.e. having a high credit rating, (although this is defined by the council, and no guidelines are given), and high liquidity investments, in sterling with a maturity of no more than one year.

- non-specified investments: covers all other investments, which may have a maturity of greater than one year or lower security rating or both.

The Annual Investment Strategy within the treasury management strategy is approved by full council.

All limits in the investment strategy apply to both in-house and externally managed funds.

Specified Investments

These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the council has the right to be repaid within 12 months if it wishes. These are low risk assets where the possibility of loss of principal or investment income is negligible. These investments are categorised as:

1. UK Government (such as the Debt Management Office, UK Treasury Bills or gilts with less than one year to maturity)
2. Supranational bonds of less than one year's duration

3. A local authority, parish council or community council
4. An investment scheme that has been awarded a high credit rating by a credit rating agency
5. A body that has been awarded a high credit rating by a credit rating agency (such as a bank or building society)

Non-specified Investments

Non-specified investments are any other type of investment (i.e. not defined as specified). These investments are categorized as:

1. Supranational bonds greater than 1 year to maturity.
2. Gilt edged securities.
3. Building societies not meeting the basic security requirements under the specified investments.
4. Any bank or building society that has a minimum long term credit rating as shown in table 4, for deposits with a maturity of greater than one year.
5. Any non-rated subsidiary of a credit rated institution included in the specified investment category.
6. Share capital in a body corporate.
7. Corporate bonds
8. Property

These categories of investment will vary in their levels of risk, and the return that may be expected from them. The identification and rationale supporting the selection investments and the maximum limits to be applied are set out in annexe 1.

Credit and counterparty risk management

The council regards the prime objective of its treasury management activities to secure the principle sums invested, whilst maximising of investment returns, within a level of risk that is acceptable to the council. It will ensure that its counterparties and limits, reflect a prudent attitude towards organisations with whom funds may be deposited, and will limit its investment activities to the instruments listed below. It also recognises the need to have, and will therefore maintain, a formal counterparty policy in respect of those organisations from which it may borrow, or with whom it may enter into other financing arrangements.

The following counterparties and limits will apply in aggregate to both internally and externally managed funds, as measured at the time of investment:

- *Banks and building society deposits*

  A maximum sum of £15 million can be lent to any one individual bank or building society providing it meets the minimum credit rating criteria set out in the investment strategy.

- *UK government or local authorities*

  A maximum sum of £15 million could be lent to a local authority or UK Government.

- *Supranational bonds*

  The maximum sum that can be invested in supranational bonds is £15 million.

- *Gilt edged securities*

  The maximum investment, excluding investment returns, to be invested in Gilt Edged Securities is £15 million.

- *Corporate bonds*

  The maximum sum that can be invested in United Kingdom Corporate Bonds is £10 million.

- *Equities*

  The maximum sum, excluding investment returns that can be invested in United Kingdom equities is £10 million, but only through the purchase of units of Index Tracking Trusts. As approved by council, the investment returns from the equities are re-invested in this investment instrument.

- *Money Market Funds (MMF)*

  The maximum sum to be invested in MMFs is £20 million. Government legislation restricts authority's access only to those MMFs with the highest possible credit rating (AAA).

- *Bond Funds*

  The maximum to be invested in a pooled bond fund is £5m and only those that have a AAAf rating should be considered.

- *The government's debt management account deposit facility (DMCDF)*

  The maximum sum to be invested in the government's DMA Deposit Facility is 100 percent of the total investment portfolio.

- *Property investment linked funds*

  The maximum amount to be invested in property / property type funds is £10 million. This would be subject to receipt of specialist advice from the council's strategic property advisors and treasury advisors and would be the subject of a separate report to cabinet/council.

Investment spread

As a guideline, it is recommended that the council's investment in any one of the council's approved investment instruments should not exceed the maximum percentage / monetary limits listed below:

Cash deposits	80%
Supranational bonds	£15m
Gilts	£15m
Equities	£10m
Corporate bonds	£10m
Money market funds	£20m
Pooled Bond Fund	£ 5m
Property	£20m
External fund manager	£20m
Debt management account deposit facility	100%

Security, liquidity and yield benchmarking

Security and liquidity benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons in the annual outturn report. For yield, benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments – internal returns above the 7 day LIBID rate

Security and liquidity benchmarks are intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. Proposed benchmarks for the cash type investments are below and these will form the basis of future reporting in this area. In the other investment categories appropriate benchmarks will be used where available.

Liquidity – This is defined as “having adequate, though not excessive cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives” (CIPFA Treasury Management Code of Practice). In respect of this area the council seeks to maintain:

- Bank overdraft - £0.5 million
- Liquid short term deposits of at least £10 million available with a week’s notice.

The availability of liquidity and the term risk in the portfolio is benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – shorter WAL would generally embody less risk. In this respect the proposed benchmark is to be used:

- WAL benchmark is expected to be 0.5 years, with a maximum of three years.

Security of the investments – In context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody’s and Standard and Poors). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic.

One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the council’s annual investment strategy. The table below shows average defaults for differing periods of investment grade products for each Fitch long term rating category over the period 1990 to 2007.

Long term rating	1 year	2 years	3 years	4 years	5 years
AAA	0.00%	0.00%	0.00%	0.00%	0.00%
AA	0.00%	0.00%	0.00%	0.03%	0.06%
A	0.03%	0.15%	0.30%	0.44%	0.65%
BBB	0.24%	0.78%	1.48%	2.24%	3.11%

The council’s minimum long term rating criteria is currently “A”, meaning the average expectation of default for a one year investment in a counterparty with a “A” long term rating would be 0.03 per cent of the total investment (e.g. for a £1 million investment the average loss would be £300). This is only an average - any specific counterparty loss is likely to be higher - but these figures do act as a proxy benchmark for risk across the portfolio.

The council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables, is:

- % historic risk of default when compared to the whole portfolio.

And in addition that the security benchmark for each individual year is:

	1 year	2 years	3 years	4 years	5 years
Maximum	0.03%	0.15%	0.30%	0.44%	0.65%

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to members in the annual outturn report. As this data is collated, trends and analysis will be collected and reported. Where a counterparty is not credit rated a proxy rating will be applied.