Report to:

Audit and corporate governance committee
Cabinet
Council

South Oxfordshire District Council

Listening Learning Leading

AGENDA ITEM NO 12

Report of Head of Finance

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To: Audit & Corporate Governance Committee	30 January 2012
To: Cabinet	13 February 2012
To: Council	22 February 2012

Treasury management strategy 2012/13

Recommendations:

That audit and corporate governance committee:

1. Scrutinise the treasury management strategy and policy and if required make recommendations for amendment to cabinet.

That cabinet recommends council to approve:

2. the treasury management strategy 2012/13, incorporating the annual investment strategy, which is contained within appendix A of the report of the head of finance to cabinet on 13 February 2012,

3. The prudential indicators and limits for 2012/13 to 2015/16, which are contained within appendix A and annexe 2 of the report of the head of finance to cabinet on 13 February 2012.

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 treasury activities are controlled and managed.

6. The current TMPs and the revised Code were adopted on 25 April 2002. 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 2011/12 treasury management strategy on 14 February 2011. The proposed strategy for 2012/13 includes the changes detailed below, which cabinet is asked to recommend to council:

    a) To provide the facility to investment a further £20 million in property, either directly or via a pooled property linked fund.

    b) To allow the direct purchase of certificates of deposit (CD's).

    c) To raise the limit that can be invested in UK banks that have government support from £15 million to £20 million.

10. The first change above, is proposed so that the council has the facility to expand the current investments that are linked to property in the council's portfolio. This will improve the investment portfolio spread across sectors and reduce the amount that is invested directly in cash deposits. The investment may be in direct property purchase, or indirectly via a pooled fund across the property sector that can be sold quickly, if required. Both options have advantages and disadvantages. Any such investment would only be made after a review of the options available and in comparison with direct property investment options and after taking expert advice. The strategy will continue to adhere to the investment fundamentals, i.e. giving priority first to security, then to liquidity and finally yield.

11. The second change is proposed to allow officers to invest in CD's directly. The strategy already provides the facility for the council to use this type of investment, indirectly through a fund manager. This option has been reviewed, and it is possible for the council to invest directly in this type of investment, without the use of a fund manager, as the council has custodian account facilities in place. The use of CD's would allow exposure to high rated counterparties, which would otherwise not be available to the council, as they do not borrow through the money markets using cash deposits. It would also improve the council's spread of risk, by allowing the use of other highly rated banks.

12. The third change is required due to the limited number of counterparties currently available to the council. As the issues in the Eurozone continue, the council has restricted lending to UK registered banks. UK part nationalised banks carry the sovereign rating and therefore have the highest level of security available for a term deposit. In order to place deposits with institutions that carry the highest security, it is necessary to raise the total limit that can be lent to a part nationalised institution in the UK from £15 million to £20 million.

Financial implications

13. 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 few years investment income has fallen due to the lower interest rates that have been available 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 £66 million by 2015/16.

14. 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.

Table 1: Investment income projections.

	2011/12 £000's	2012/13 £000's	2013/14 £000's	2014/15 £000's	2015/16 £000's
Average balances	89,631	85,486	76,707	69,285	65,664
Working capital	15,000	15,000	15,000	15,000	15,000
Estimate of average balance in year	104,631	100,486	91,707	84,285	80,664
Forecast average interest rate	1.86%	2.25%	2.50%	3.00%	3.00%
Forecast investment income	1,950	2,506	2,287	2,570	2,470
Less non-distributable income	(250)	(250)	(250)	(250)	(250)
Forecast distributable income	1,700	2,256	2,037	2,320	2,220

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

15. The 2012/13 budget setting report takes into account the latest projections of anticipated investment income.

Legal implications

16. 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.

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

Conclusion

18. This report provides details of the proposed treasury management strategy and the annual investment strategy for 2012/13, 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 2011, council 24 February 2011)

Appendices

Appendix A	Treasury Management Strategy 2012/13 – 2015/16	
	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

Treasury management strategy

(Incorporating the annual investment strategy)

Background information

1. The 2011/12 treasury management strategy was approved by council on 24 February 2011. 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:

a) The Local Government Act 2003 and the CIPFA Prudential Code;
b) The latest Code of Practice on Treasury Management published by the Chartered Institute of Public Finance and Accountancy ("the Code");
c) The Treasury Management Policy and council financial regulations, which require a treasury management strategy to be reported to council for the forthcoming year.
d) 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. Further treasury reports are required as a minimum : a mid-year monitoring report which covers the first six months of each year and at year-end a report on the actual activity for the year.

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. In October 2011 the contract for treasury management advisors was jointly re-tendered with the Vale of White Horse District Council (VWHDC). A three year contract was awarded to Sector Treasury Services Limited, a subsidiary of the Capita Group Plc.

6. 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

7. The council's investment portfolio has averaged at approximately £105 million through 2011. 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.

8. The objective of the 2011/12 strategy was to keep investments short–term due to the uncertainty in the financial markets. The majority of investments have therefore been placed for less than one year, but where possible officers have sought to extend maturity periods to between one and three years.

9. The maturity period of investments has been lengthened by a few longer dated deposits only when 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.

10. Total investment income is predicted to fluctuate between a range of £1.9 million in 2011/12 to £2.5 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.

11. The council's investment position as at 31 December 2011 is shown in table 2 below. It shows that roughly seven per cent of the entire investment portfolio is held on call or in notice accounts, and that 82 per cent of the total investment portfolio is held in cash deposits.

Table 2: maturity structure of investments as at 31 December 2011 :

	Total	
	£000	%
Cash deposits:		
Call	7,431	6%
30 day notice	1,479	1%
Up to 1 month	7,500	6%
1 - 2 Months	14,500	12%
2-3 Month	6,000	5%
3-4 Month	6,500	6%
4-6 Month	4,500	4%
6-12 Month	17,000	14%
1 -2 Year	28,000	24%
2-5 Year	3,000	3%
Kaupthing Singer & Friedlander	579	0%
Total cash deposits	**96,488**	**82%**
Equities	12,567	11%
Corporate bonds	4,266	3%
Money market funds	4,750	4%
Overall total	**118,072**	**100%**

(Total excludes property investments and maturity periods refer to time remaining to end of term).

Icelandic banks – Kaupthing Singer & Friedlander (KSF)

12. 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 £1.6 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.

13. 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.

14. The administrator's intend to make further payments at regular intervals. The next report is scheduled for April 2012. The latest creditors report now indicates that the estimated total amount to be recovered should be in the range of 79p to 86p in the £. In total terms this would mean receiving between £2,078,358 and £2,262,517 of the claim. This is an increase from the previous report which indicated 75p in the £.

Investment performance for the year to 31 December 2011.

15. The council's budgeted investment return for 2011/12 is £1.8 million, and the actual interest earned to date is shown in table 3. 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 higher than the original forecast reported in the Medium Term Financial Strategy.

Table 3 : Investment interest earned by investment type

Investment type	Interest Earned Apr - Dec 2011			
	Annual Budget £000's	Actual To 31.12.11 £000's	Forecast 2011/12 £000's	Variation £000's
Call accounts	75	38	59	(16)
cash deposits < 1 yr	476	376	474	(2)
Cash deposits > 1 yr	586	715	1,005	419
MMF	3	30	37	34
Corporate bonds	463	335	433	(30)
Transferred Debt	10	0	10	0
Total Distributable Interest	**1,613**	**1,494**	**2,018**	**405**
Equities*	250	167	398	148
Total Interest	**1,863**	**1,661**	**2,416**	**553**

* Interest on equities not included in annual budget as nondistributable

16. The portfolio has outperformed the benchmarks for the year to date. Internally managed investments have exceeded the benchmark by 0.94 per cent. The following table highlights the actual returns achieved to the 31 December 2011.

Table 4: investment returns achieved against benchmark

	Benchmark return %	Actual return %	Growth (below)/above benchmark %	Benchmarks
Bank & building society deposits - non-managed	0.78%	1.72%	0.94%	3 Month LIBID
Equities	-7.51%	-2.72%	4.79%	FTSE all shares index
Corporate bonds	0.50%	5.68%	5.18%	BoE base rate

Economic conditions and interest rate forecasts

17. 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. Uncertainty continues throughout the global economy. The Eurozone (EZ) crisis dominates the financial markets this year and will remain until fundamental issues over the fate and structure of the currency in the EZ are resolved. This is important for the UK because the outcome and resolution (or non-resolution) of the crisis will have a significant impact on the British economy. There is a risk of a major crisis in the Euro area if there are further falls in sovereign debt confidence together with weak growth could move the euro area into recession.

18. Economic growth in the UK is weak and is expected to remain so for the next two years. The latest economic forecasts by the UK Government have reduced growth

projections from 2.5 per cent to 0.7 per cent in 2012, and from 2.9 per cent to 2.1 per cent in 2013. Unemployment in the UK has risen to a 17 year high of 2.64 million and is forecast to peak around 2.85 million in 2013. Twelve month CPI inflation has fallen from 5 per cent in October to 4.2 per cent in December. The levels are well above the 2 per cent the Bank of England's Monetary Policy Committee (MPC) target, which reported the increase in standard rate of VAT, higher energy and import prices as the main factors. The MPC's forecast expects inflation to fall sharply in 2012 as the impact of these factors disappear. The Committee's view is that domestic inflation will be reduced by unemployment and spare capacity. As expected, the MPC kept rates on hold at the meeting on 12 January 2012.

19. Libor three month rates have risen which indicates continued stress in the short-term unsecured bank funding markets. At the time of writing this report, short term rates are expected to remain at 0.5 per cent until the second half of 2013. The uncertain economic outlook has several key implications for treasury management:

    - The sovereign debt issues provide a clear indication of higher counterparty risk.
    - Investment returns are likely to remain low for 2012/13.
    - Borrowing rates are attractive and may remain low for some time.

20. Sector treasury advisors assist the council in formulating a view on interest rates. Table 5 below shows Sectors' forecast of the expected movement in interest rates, in the short term.

Table 5: Interest Rate Forecasts - 2012/2013

			Money market rates %		PWLB Rates*	
Year	End period	BoE Base Rate	3mth	12mth	5yr	25yr
2012	Mar	0.50	0.70	1.50	2.30	4.20
	Jun	0.50	0.70	1.50	2.30	4.20
	Sep	0.50	0.70	1.50	2.30	4.30
	Dec	0.50	0.70	1.60	2.40	4.30
2013	Mar	0.50	0.75	1.70	2.50	4.40
	Jun	0.50	0.80	1.80	2.60	4.50
	Sep	0.75	0.90	1.90	2.70	4.60
	Dec	1.00	1.20	2.20	2.80	4.70
2014	Mar	1.25	1.40	2.40	2.90	4.80
	Jun	1.50	1.60	2.60	3.10	4.90

* Borrowing Rates.
Source: Sector - December 2011

Borrowing strategy 2012/13 – 2016/17

21. 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.

22. 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.

23. 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 2012/13- 2016/17

Background

24. 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.

25. 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

26. 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)

a. Bank and building society cash deposits
b. Deposits with UK local authorities
c. UK Government – DMADF, treasury stock (Gilts) with less than one year to maturity
d. Debt Management Agency Deposit Facility (DMADF)
e. Money Market Funds (MMF) (AAA rated)
f. Pooled Bond funds (AAAf rated)
g. Certificates of deposits with banks and building societies

Non-specified investment instruments (beyond 1 year)

h. Bank and building society cash deposits up to 5 years
i. Deposits with UK local authorities up to 5 years
j. Corporate bonds
k. Pooled property or bond funds
l. UK pooled equity funds
m. UK treasury stock (Gilts) up to 10 years
n. Supranational bonds up to 10 years
o. Direct property investment

Cash deposits

27. 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.

28. 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.

29. Cash deposits can be made with UK local authorities up to a period of five years and a maximum of £15 million 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

30. Gilts (or 'gilt-edged stocks') are bonds issued by the UK government which pay a fixed rate of interest usually 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.

Government's debt management account deposit facility (DMADF)

31. 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.

Money market funds (MMFs)

32. 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).

33. 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.

Certificates of deposit

34. 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 purchase of these investments to be held until maturity.

Corporate bonds

35. 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.

36. 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 £4.2 million as at 31 December 2011.

37. The remaining bonds are providing an excellent rate of return. 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. Given the current uncertainty and higher risk, it is not a recommended option at this time.

Property – direct investment

38. The council is 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.

39. The council is reviewing further investment in property in conjunction with the council's property advisors, a report will be brought forward in the year ahead. The treasury management strategy allows for a further investment of up to £20 million in either direct property holdings (as measured at the time of purchase) or indirect property investments.

40. The council currently retain properties for investment purposes. As at the end of March 2011, the latest period for which audited figures are available, these had an aggregate book value of £16.2 million.

Property – indirect investment

41. The council is able to invest in property investment funds. These are pooled investments where units are purchased. The fund invests in a cross section of property ie: commercial, industrial, retail and residential. This type of investment is highly liquid as units can be sold quickly if required. They are also exempt from capital accounting as disposal income does not have to be treated as a capital receipt. This can give greater flexibility in the use of future income. The disadvantage of this type of fund is that they have a high entry fee and annual management charges. The council is reviewing the investment in this type of product with the assistance of the council's treasury advisors (Sector) to assess which products may be suitable. The strategy provides for investment up to £10 million in a property related investment fund.

Bond funds

42. 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

43. '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.

44. 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.

45. 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.

46. 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).

47. As these investments fluctuate significantly over short periods of time, they are kept under constant review. When the current holdings reach £14 million, a further £2 million will be disposed of.

Supranational bonds

48. 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

49. 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 in the medium term with highly rated institutions when possible. With the aim of increasing the weighted average maturity of the portfolio. A full list of investments held as at 31 December 2011, is shown in annexe 1a.

50. Officers will continue to implement an operational strategy which provides tight controls on the investments placed. Where possible opportunities to spread the investment risk over different types of instruments will be considered. Officers have expanded investments in the current year to Local Authorities, and will continue to seek opportunities to invest in this particular area.

51. 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).

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

53. 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.

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

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

Counterparty selection

56. 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.

57. 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.

58. 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:

    I. 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);

    II. 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.

59. 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.

60. 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 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.

9. Local Authorities

10. Supranational institutions

Country and sector considerations

61. 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 section 60 above. Sector limits will be monitored and reviewed regularly.

Use of additional information to supplement credit ratings

62. 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.

63. 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

64. 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 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.

65. 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

66. 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.

67. 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 6 below.

    I. **Upper limits on fixed interest rate exposure** – this covers a maximum limit on fixed interest rates.

    II. **Upper limits on variable interest rate exposure** – this identifies a maximum limit for variable interest rates based upon the debt position net of investments.

    III. **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.

    IV. **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 6: treasury management limits on activity

	2012/13	2013/14	2014/15	2015/16
Investments	Estimate	Estimate	Estimate	Estimate
	£m	£m	£m	£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	70	70	70	70
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

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

69. 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

70. 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.

71. 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:

72. **Security** – the council's maximum security risk benchmark for the current portfolio, when compared to the historic default tables is per cent 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	0.235%	0.685%	0.191%	1.788%	2.422%

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

73. **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.

74. **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.

75. 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 per cent 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.

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

Other prudential indicators

77. 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

78. 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 provided member providing member training on treasury management.

Summary

79. 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.

80. 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 2012/13

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	Max limit per	Time
Specified instrument:	**S/term**	**L/term**	**Indiv.**	**Support**	**S/term**	**L/term**	**FSR**	**S/term**	**L/term**	**backing £m**	**for wholesale deposits**	**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
Bank - cerificates of deposit	F1	AA-	B	2	P1	Aa3	B	A1	AA-	-		£15m	4 years
UK Bank part nationalised												£20m	I year
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 and Local Authorities												£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 - certificates of deposit	F1	AA-	B	2	P1	Aa3	B	A1	AA-	-		£15m	4 years
Bank subsidiary	*				*			*		*		£15m	*
UK Bank part nationalised												£20m	5 years
UK equities												£10m	No Limit
Property related invetsments												£30m	n/a
UK govt and Local Authorities												£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)	70

Investments held at 31 December 2011

Start Date	Counterparty	Principal	Maturity Date	Rate	Country	Sector Limits	Current Long Term Rating	Specified	Historic Risk of default	Risk Weighting
A	B	C	D	E	F	G	H	I	J	K=CxJ
31/12/2011	Santander UK Plc	£4,729,000	01/01/2012	0.80%	UK	Banks - UK - Call Accounts	AA-	Yes	0.000%	4
31/12/2011	Santander UK Plc	£1,478,574	01/01/2012	0.90%	UK	Banks - UK - Call Accounts	AA-	Yes	0.000%	1
31/12/2011	Royal Bank of Scotland	£2,274	01/01/2012	0.85%	UK	Banks - UK - Call Accounts	AA-	Yes	0.000%	0
31/12/2011	Goldman Sachs	£2,370,000	01/01/2012	0.60%	UK	MMF	AAA	Yes	0.000%	-
31/12/2011	Deutsche Bank	£1,800,000	01/01/2012	0.60%	UK	MMF	AAA	Yes	0.000%	-
31/12/2011	Blackrock	£580,000	01/01/2012	0.60%	UK	MMF	AAA	Yes	0.000%	-
26/03/2002	Royal Bank of Scotland	£1,516,650	22/06/2015		UK	Corporate Bonds	AA-	No	0.107%	1,621
20/03/2003	Halifax	£2,114,400	17/01/2014		UK	Corporate Bonds	AA-	No	0.057%	1,213
15/04/2003	Santander UK Plc	£294,435	04/01/2017		UK	Corporate Bonds	AA-	No	0.205%	603
01/04/2001	L&G Equities	£12,566,591	01/01/2012		UK	Other	none	No	0.001%	81
12/07/2010	Royal Bank of Scotland	£5,000,000	12/07/2012	2.00%	UK	Banks - UK	AA-	No	0.015%	726
03/09/2010	Lloyds TSB Bank	£4,000,000	03/09/2012	2.45%	UK	Banks - UK	AA-	No	0.018%	740
02/12/2010	Royal Bank of Scotland	£5,000,000	02/12/2013	2.82%	UK	Banks - UK	AA-	No	0.054%	2,705
23/03/2011	Santander UK Plc	£2,000,000	15/03/2012	2.10%	UK	Building Societies - Term	AA-	No	0.006%	112
15/04/2011	Progressive Building Society	£2,000,000	05/01/2012	1.40%	UK	Building Societies - Term	NONE	No	0.003%	64
19/04/2011	Newcastle City Council	£3,000,000	17/04/2012	1.75%	UK	Local Authorities	AAA	No	0.000%	-
26/04/2011	Brentwood Borough Council	£2,000,000	26/04/2013	2.16%	UK	Local Authorities	AAA	No	0.004%	90
16/05/2011	Nottingham Building Society	£2,500,000	16/02/2012	1.22%	UK	Building Societies - Term	none	No	0.030%	758
27/05/2011	National Counties Building Society	£3,000,000	27/02/2012	1.55%	UK	Building Societies - Term	none	No	0.037%	1,122
01/07/2011	Lloyds TSB Bank	£5,000,000	28/06/2013	2.80%	UK	Banks - UK	AA-	No	0.042%	2,082
15/07/2011	Furness Building Society	£3,500,000	16/01/2012	1.30%	UK	Building Societies - Term	none	No	0.010%	361
15/07/2011	Bank of Scotland Plc	£2,000,000	05/01/2012	1.40%	UK	Banks - UK	BBB-	Yes	0.003%	64
02/08/2011	Leek United Building Society	£1,500,000	02/02/2012	1.35%	UK	Building Societies - Term		No	2.173%	32,590
30/08/2011	Manchester Building Society	£2,500,000	07/02/2012	1.30%	UK	Building Societies - Term	None	No	0.025%	613
01/09/2011	Bank of Scotland Plc	£1,000,000	15/03/2012	1.42%	UK	Banks - UK	BBB-	Yes	0.048%	484
01/09/2011	Progressive Building Society	£2,000,000	15/03/2012	1.35%	UK	Building Societies - Term	None	No	0.048%	967
03/10/2011	Nationwide Building Society	£2,500,000	05/04/2012	1.19%	UK	Building Societies - Term	AA-	Yes	0.007%	180
07/10/2011	Barclays Bank	£2,000,000	07/10/2013	2.60%	UK	Banks - UK	AA-	Yes	0.050%	993
01/01/2011	Bank of Scotland Plc	£3,000,000	01/11/2013	2.80%	UK	Banks - UK	BBB-	Yes	0.612%	18,361
01/01/2011	Santander UK Plc	£3,000,000	07/02/2012	1.32%	UK	Banks - UK	AA-	No	0.003%	85
04/11/2011	Barclays Bank	£5,000,000	05/11/2012	1.75%	UK	Banks - UK	AA-	Yes	0.023%	1,161
04/11/2011	National Counties Building Society	£1,000,000	04/04/2012	1.20%	UK	Building Societies - Term	none	No	0.061%	613
04/11/2011	National Counties Building Society	£1,500,000	04/05/2012	1.35%	UK	Building Societies - Term	none	No	0.081%	1,209
04/11/2011	Progressive Building Society	£2,000,000	07/02/2012	1.00%	UK	Building Societies - Term	none	No	0.025%	490
10/11/2011	Hinckley & Rugby Building Society	£2,000,000	10/08/2012	1.65%	UK	Building Societies - Term	none	No	0.144%	2,876
14/11/2011	Barclays Bank	£3,000,000	14/11/2013	2.75%	UK	Banks - UK	AA-	Yes	0.053%	1,580
14/11/2011	Kingston upon Hull City Council	£1,000,000	15/06/2015	1.90%	UK	Local Authorities	AAA	No	0.073%	728
15/11/2011	Hinckley & Rugby Building Society	£2,000,000	15/05/2012	1.30%	UK	Building Societies - Term	none	No	0.088%	1,754
01/12/2011	Nationwide Building Society	£1,000,000	07/09/2012	1.57%	UK	Building Societies - Term	AA-	Yes	0.019%	188
01/12/2011	Santander UK Plc	£1,000,000	01/03/2012	1.44%	UK	Banks - UK	AA-	No	0.005%	46
01/12/2011	Royal Bank of Scotland	£1,500,000	02/12/2013	3.25%	UK	Banks - UK	AA-	No	0.054%	812
01/12/2011	Royal Bank of Scotland	£1,500,000	02/12/2013	3.10%	UK	Banks - UK	AA-	Yes	0.054%	812
02/12/2011	Market Harborough Building Society	£1,000,000	06/06/2012	1.60%	UK	Building Societies - Term	none	Yes	0.102%	1,019
02/12/2011	Barclays Bank	£2,000,000	02/12/2014	3.75%	UK	Banks - UK	AA-	Yes	0.075%	1,508

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

	2012/13 Estimate £m	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 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 2012/13 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:

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

c) A local authority, parish council or community council
d) An investment scheme that has been awarded a high credit rating by a credit rating agency
e) 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:

f) Supranational bonds greater than 1 year to maturity.
g) Gilt edged securities.
h) Building societies not meeting the basic security requirements under the specified investments.
i) 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.
j) Any non-rated subsidiary of a credit rated institution included in the specified investment category.
k) Share capital in a body corporate.
l) Corporate bonds
m) Property direct property investment
n) Pooled property fund investment

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 – cash and certificates of 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.
- *Banks – part nationalised*
  A maximum sum of £20 million can be lent to any one individual bank that is part nationalised.

- *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 per cent of the total investment portfolio.

- *Property investment linked funds*

  The maximum amount to be invested in property related 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.

- *Property- direct investment*

  The maximum amount to be invested directly in property is £30 million. This would be subject to receipt of specialist advice from the council's strategic property 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 per centage / monetary limits listed below:

Cash and certificates of deposit	85%
Supranational bonds	£15m
Gilts	£15m
Equities	£10m
Corporate bonds	£10m
Money market funds	£20m
Pooled Bond Fund	£ 5m
Property - direct investments	£30m
Property related pooled fund	£10m
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 2008.

Long term rating	1 year	2 years	3 years	4 years	5 years
AAA	0.000%	0.014 %	0.051%	0.099%	0.165%
AA	0.027%	0.056%	0.077%	0.140%	0.205%
A	0.077%	0.215%	0.367%	0.517%	0.699%
BBB	0.235%	0.685%	1.191%	1.788%	2.422%

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 0.077 per cent of the total investment (e.g. for a £1 million investment the average loss would be £700). 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.