DEVON & SOMERSET FIRE & RESCUE AUTHORITY

REPORT REFERENCE NO.	**DSFRA/10/3**
MEETING	**DEVON & SOMERSET FIRE & RESCUE AUTHORITY (BUDGET MEETING)**
DATE OF MEETING	**19 FEBRUARY 2010**
SUBJECT OF REPORT	**TREASURY MANAGEMENT STRATEGY (INCLUDING PRUDENTIAL AND TREASURY INDICATORS REPORT 2010/11 TO 2012/13)**
LEAD OFFICER	**Treasurer**
RECOMMENDATIONS	***That the following be approved;*** ***(a) the Treasury Management Strategy and the Annual Investment Strategy, including the adoption of the revised CIPFA Treasury Management Code of Practice 2009, as contained as Appendix A to this report,*** ***(b) the prudential indicators and limits, as contained as Appendix B;*** ***(c) the Minimum Revenue Provision (MRP) statement for 2010/2011, as contained as Appendix C;*** ***(d) that the Treasurer be delegated authority to effect movements between the separately agreed prudential limits for borrowing;*** ***(e) that the statement at paragraph 5.8 of this report that borrowing limits and the debt management strategy have been set to ensure that net borrowing remains below the capital financing requirement for 2010/2011 to 2012/2013, in line with the requirements of the CIPFA Prudential Code, be noted.***
EXECUTIVE SUMMARY	This report sets out a revised treasury management strategy and investment strategy for 2010/2011, including the Prudential Indicators associated with the capital programme for 2010/2011 to 2012/2013 considered elsewhere on the agenda of this meeting. A Minimum Revenue Provision Statement for 2010/2011 is also included for approval. Following the Icelandic bank situation in 2008, CIPFA have issued a revised Treasury Management Code of Practice 2009. The Authority is asked to formally adopt this revised Code for inclusion within the existing Treasury Management Policy.

RESOURCE IMPLICATIONS	As indicated in this report
EQUALITY IMPACT ASSESSMENT	None
APPENDICES	A. Adoption of the Revised CIPFA Treasury Management Code of Practice. B. Prudential and Treasury Management Indicators 2010/11 to 2012/13. C. Minimum Revenue Provision Statement 2010/2011
LIST OF BACKGROUND PAPERS	Local Government Act 2003. Chartered Institute of Public Finance Accountancy's (CIPFA) Prudential Code. Report to Resources Committee 8 December 2008 – Affordable Capital Investment Plans for 2009/2010 to 2011/2012

1. INTRODUCTION

The Revised CIPFA Treasury Management Code of Practice 2009

1.1 In the light of the Icelandic situation in 2008, the Chartered Institute of Public Finance and Accountancy (CIPFA) has amended the CIPFA Treasury Management in the Public Services Code of Practice (the Code), Cross-Sectoral Guidance Notes and Guidance Notes and the template for the revised Treasury Management Policy Statement. It is also a requirement of the Code that this Authority should formally adopt the Code. Appendix A provides the necessary changes to be made to the existing DSFRA Treasury Management Policy to adopt the revised Code.

1.2 The revised Code has emphasised a number of key areas including the following: -

(a). All authorities must formally adopt the revised Code and four clauses

(b). The strategy report will affirm that the effective management and control of risk are prime objectives of the Authority's treasury management activities.

(c). The Authority's appetite for risk must be clearly identified within the strategy report and will affirm that priority is given to security of capital and liquidity when investing funds and explain how that will be carried out.

(d). Responsibility for risk management and control lies within the organisation and cannot be delegated to any outside organisation.

(e). Credit ratings should only be used as a starting point when considering risk. Use should also be made of market data and information, the quality financial press, information on government support for banks and the credit ratings of that government support.

(f). Authorities need a sound diversification policy with high credit quality counterparties and should consider setting country, sector and group limits.

(g). Borrowing in advance of need is only to be permissible when there is a clear business case for doing so and only for the current capital programme or to finance future debt maturities.

(h). The main annual treasury management reports MUST be approved by full Authority.

(i). There needs to be, at a minimum, a mid-year review of treasury management strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved.

(j). Each authority must delegate the role of scrutiny of treasury management strategy and policies to a specific named body.

(k). Treasury management performance and policy setting should be subjected to prior scrutiny.

(l). Members should be provided with access to relevant training.

(m). Those charged with governance are also personally responsible for ensuring they have the necessary skills and training.

(n). Responsibility for these activities must be clearly defined within the organisation.

(o). Officers involved in treasury management must be explicitly required to follow treasury management policies and procedures when making investment and borrowing decisions on behalf of the Authority (this will form part of the updated Treasury Management Practices).

1.3 This strategy statement has been prepared in accordance with the revised Code. Accordingly, the Authority's Treasury Management Strategy will be approved annually by the full authority and there will also be a mid-year report. In addition, there will be monitoring reports and regular review by members of the Resources Committee. The aim of these reporting arrangements is to ensure that those with ultimate responsibility for the treasury management function appreciate fully the implications of treasury management policies and activities, and that those implementing policies and executing transactions have properly fulfilled their responsibilities with regard to delegation and reporting.

1.4 This Authority will adopt the following reporting arrangements in accordance with the requirements of the revised Code: -

Area of Responsibility	Authority/ Committee/ Officer	Frequency
Treasury Management Policy Statement (revised)	Full authority	Initial adoption in 2010
Treasury Management Strategy / Annual Investment Strategy / MRP policy	Full authority	Annually before the start of the year
Treasury Management Strategy / Annual Investment Strategy / MRP policy – mid-year report	Full authority	Mid year
Treasury Management Strategy / Annual Investment Strategy / MRP policy – updates or revisions at other times	Full authority	
Annual Treasury Outturn Report	Full authority	Annually by 30 September after the end of the year
Treasury Management Monitoring Reports	Resources Committee	
Treasury Management Practices	Full authority	
Scrutiny of treasury management performance	Resources Committee	

Revised CIPFA Prudential Code

1.5 CIPFA has also issued a revised Prudential Code which primarily covers borrowing and the Prudential Indicators. Three of these indicators have now been moved from being Prudential Indicators to being Treasury Indicators: -

- authorised limit for external debt
- operational boundary for external debt
- actual external debt.

1.6 However, all indicators are to be presented together as one suite. In addition, where there is a significant difference between the net and the gross borrowing position, the risks and benefits associated with this strategy should be clearly stated in the annual strategy.

Revised Investment Guidance

1.7 It should also be noted that the Department of Communities and Local Government is currently undertaking a consultation exercise on draft revised investment guidance which will result in the issue of amended investment guidance for English local authorities to come into effect from 1 April 2010. A separate report will be made to members to inform them when this guidance has been finalised. It is not currently expected that there will be any major changes required over and above the changes already required by the revised Code.

Treasury Management Strategy for 2010/11

1.8 The Local Government Act 2003 (the Act) and supporting regulations requires the Authority to 'have regard to' the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years to ensure that the Authority's capital investment plans are affordable, prudent and sustainable.

1.9 The Act therefore requires the Authority to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance issued subsequent to the Act) (included as paragraph 9 of this report); this sets out the Authority's policies for managing its investments and for giving priority to the security and liquidity of those investments.

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

- treasury limits in force which will limit the treasury risk and activities of the Authority
- Prudential and Treasury Indicators
- the current treasury position
- the borrowing requirement
- prospects for interest rates
- the borrowing strategy
- policy on borrowing in advance of need
- debt rescheduling
- the investment strategy
- creditworthiness policy
- policy on use of external service providers
- the MRP strategy
- Balanced Budget Requirement

1.11 It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the Authority to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore, means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from:-

- increases in interest charges caused by increased borrowing to finance additional capital expenditure, and
- Any increases in running costs from new capital projects are limited to a level which is affordable within the projected income of the Authority for the foreseeable future.

2. TREASURY LIMITS FOR 2010/11 to 2012/13

2.1 It is a statutory duty under Section 3 of the Act and supporting regulations, for the Authority to determine and keep under review how much it can afford to borrow. The amount so determined is termed the "Affordable Borrowing Limit". In England and Wales the Authorised Limit represents the legislative limit specified in the Act.

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

2.3 Whilst termed an "Affordable Borrowing Limit", the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years, details of the Authorised Limit can be found in paragraph 5.8 of this report.

3. CURRENT PORTFOLIO POSITION

3.1 The Authority's treasury portfolio position at 31/12/09 comprised:

TABLE 1		Principal £m	Average Rate %
Fixed Rate Funding	PWLB	26.850	3.8
Variable Rate Funding	PWLB	0	-
Other Long Term liabilities		0	
Gross Debt		26.850	3.8
Total Investments		(11.960)	
Net Debt		14.890	

4. BORROWING REQUIREMENT

4.1 The Authority's borrowing requirement is as follows:

TABLE 2	2008/9 £m	2009/10 £m	2010/11 £m	2011/12 £m	2012/13 £m
External Debt (1 April)	16.223	19.281	26.151	32.076	33.774
New Borrowing	5.100	6.200	6.967	2.740	3.520
Replacement	0.000	1.665	0.000	0.000	0.000
Repaid	(2.042)	(0.995)	(1.042)	(1.042)	(1.899)
External Debt (31 March)	19.281	26.151	32.076	33.774	35.395

5. PRUDENTIAL AND TREASURY INDICATORS 2010/11 – 2012/13

5.1 The prudential indicators are relevant for the purposes of setting an integrated treasury management strategy. A summary of the proposed indicators are included as Appendix B to this report. Explanations of the purpose of each of these indicators are provided in the following paragraphs. The Authority is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. This was adopted on 11 April 2007 by the full authority.

5.2 It should be noted that the prudential indicators proposed within this report may be subject to change as a consequence of the introduction of International Financial Reporting Standards (IFRS), e.g. change in classification of leases. Additionally, at the time of preparing this report we are awaiting clarification of the status of the PFI project relating to Severn Park, Avonmouth, from the changes introduced by the HM treasury effective from 1 April 2009. This change has been introduced to ensure that the accounting treatment of PFI projects will be consistent with the forthcoming changes to be introduced from 1 April 2010 from IFRS.

5.3 Such changes are likely to impact on the authority prudential indicators for 2010/2011, in particular the Capital Financing Requirement (CFR). A further report will need to be presented to the authority during the year should this be the case.

Capital Expenditure

5.4 The capital expenditure plans, as proposed in the Capital Programme report considered elsewhere on the agenda, are shown in Table 3.

TABLE 3	2010/11 Estimate £m	2011/12 Estimate £m	2012/13 Estimate £m
Land and buildings	3.241	1.750	1.750
Vehicles, Plant and Equipment	3.606	2.319	2.319
TOTAL CAPITAL EXPENDITURE	6.847	4.069	4.069

5.5 Additional capital finance sources may become available during the year, for example, additional grants or external contributions. The Authority will be requested to approve increases to the capital programme to be financed from other capital resources as and when the need arises.

Capital Financing Requirement (CFR)

5.6 The Capital Financing Requirement represents the authority's underlying need to borrow for capital purposes. The forecast CFR for 2010/2011 to 2012/2013, based on the spending plans are shown in Table 4.

TABLE 4	2010/11 Estimate £m	2011/12 Estimate £m	2012/13 Estimate £m
Capital Financing Requirement as at 31 March	32.076	33.774	35.395

Limits to Borrowing Activity

5.7 Two Treasury Management Indicators control the level of borrowing. They are:

- The *authorised limit* - this represents the limit beyond which any additional borrowing is prohibited until the limit is revised by the Authority. Revision may occur during the year if there are substantial and unforeseen changes in circumstances, for example, a significant delay in achieving forecast capital receipts. In normal circumstances this limit will not require revision until the estimate for 2011/12 is revised as part of the 2011/12 budget process. Table 5 below details the recommended Authorised Limits for 2010/2011 and the medium term.
- The *operational boundary* – this indicator is based on the probable external debt during the year; it is not a limit and actual borrowing could vary around this boundary for short times during the year. Table 6 below details the recommended Operational Boundaries for 2010/2011 and the medium term.

TABLE 5	2010/11 Estimate £m	2011/12 Estimate £m	2012/13 Estimate £m
Authorised limit for External Debt			
- External Debt	38.603	40.190	41.619
- Other long term liabilities	0	0	0
TOTAL AUTHORISED LIMIT FOR EXTERNAL DEBT	38.603	40.190	41.619

TABLE 6	2010/11 Estimate £m	2011/12 Estimate £m	2012/13 Estimate £m
Operational Boundary for External Debt			
- External Debt	35.395	36.813	38.079
- Other long term liabilities	0	0	0
TOTAL OPERATIONAL BOUNDARY FOR EXTERNAL DEBT	35.395	36.813	38.079

It is estimated that the actual external debt at 31 March 2010 will be £26.151 million.

Net Borrowing in Comparison to the CFR

5.8 The debt management strategy and borrowing limits for the period 2010/11 to 2012/13 have been set to ensure that over the medium term, net borrowing will only be for capital purposes i.e. net external borrowing does not exceed the total Capital Financing Requirement in the preceding year plus the estimates for the current year and the next two years. This is demonstrated by the fact that the operational boundary for external debt borrowing in 2010/2011 of £35.395 million (Table 6) does not exceed the CFR for 2012/13 of £35.395 million (Table 4).
Prudential Indicators for Affordability

5.9 The previous sections of the report cover the overall limits for capital expenditure and borrowing, but within the overall framework indicators are also included to demonstrate the affordability of capital investment plans.

5.10 A key indicator of the affordability of capital investment plans is the ratio of financing costs to the net revenue stream; this indicator identifies the trend in the cost of capital financing (borrowing costs net of investment income) against the Authority's net budget requirement. Annual capital financing costs are a product of total debt outstanding, the annual repayment regime and interest rates. The forecast ratios for 2010/11 to 2012/13 based on current commitments and the proposed Capital Programme are included in Table 7.

TABLE 7	2010/11 Estimate %	2011/12 Estimate %	2012/13 Estimate %
Ratio of Financing Costs to Net Revenue Stream	3.80	4.38	4.63

5.11 At the meeting of Resources Committee, held on the 8 December 2008, the report 'Affordable Capital Investment plans for 2009/2010 to 2011/2012, was considered with a view to determining a level of borrowing for the Authority, which would be deemed to be affordable, sustainable and prudent. In considering this report an 'in principle' decision was, for the period 2009/2010 to 2011/12, a ceiling of 5%, for the ratio of financing costs to net revenue stream, should be adopted as a measure of affordability.

5.12 The estimate of the incremental impact of capital investment decisions proposed in the recommended Capital Programme over and above capital investment decisions that have previously been taken by the Authority are given in Table 8. These figures do not represent the total impact on the Authority tax over and above 2009/2010 as a consequence of the total capital programme, only the incremental impact over and above previous decisions made on capital investment. The figures given represent the incremental impact for a Band D property.

TABLE 8	2010/11 Estimate £ p	2011/12 Estimate £ p	2012/13 Estimate £ p
Element of Authority tax for New Capital Spending	(£0.28)	(£0.17)	(£0.07)

6. PROSPECTS FOR FUTURE INTEREST RATES

6.1 The Authority has appointed Sector Treasury Services as treasury advisor to the Authority and part of their service is to assist the Authority to formulate a view on interest rates. Sectors central view of changes in Bank Rate is shown below;

Sector Bank Rate forecast for financial year ends (March)

2010 0.50%

2011 1.50%

2012 3.50%

2013 4.50%

6.2 There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected.

7. BORROWING STRATEGY

Borrowing rates

7.1 The Sector forecast for the PWLB new borrowing rate is as follows: -

TABLE 9

	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Mar-12	Mar-13
Bank rate	0.50%	0.50%	0.75%	1.00%	1.50%	3.50%	4.50%
5yr PWLB rate	3.05%	3.20%	3.30%	3.40%	3.60%	4.60%	4.85%
10yr PWLB rate	4.00%	4.05%	4.15%	4.30%	4.45%	5.00%	5.15%
25yr PWLB rate	4.55%	4.65%	4.70%	4.80%	4.90%	5.20%	5.35%
50yr PWLB rate	4.60%	4.70%	4.75%	4.90%	5.00%	5.30%	5.45%

7.2 In view of the above forecast the Authority's borrowing strategy will be based upon the following information:

- Rates are expected to gradually increase during the year so it should therefore be advantageous to time new long term borrowing for the start of the year when 25 year PWLB rates fall back to or below the central forecast rate of about 4.65%, a suitable trigger point for considering new fixed rate long term borrowing.
- PWLB rates on loans of less than ten years duration are expected to be substantially lower than longer term PWLB rates offering a range of options for new borrowing which will spread debt maturities away from a concentration in long dated debt.
- There is expected to be little difference between 25 year and 50 year rates so therefore loans in the 25-30 year periods could be seen as being more attractive than 50 year borrowing as the spread between the PWLB new borrowing and early repayment rates is considerably less. This would maximise the potential for debt rescheduling and allow the Authority to rebalance its debt maturity profile.

- Consideration will also be given to borrowing fixed rate market loans at 25 – 50 basis points below the PWLB target rate and to maintaining an appropriate balance between PWLB and market debt in the debt portfolio.
- Any consideration of further PWLB debt will be in accordance with the authority agreed maturity structure limits, as included in Appendix B.

7.3 Sensitivity of the forecast – In normal circumstances the main sensitivities of the forecast are likely to be the two scenarios noted below. The authority officers, in conjunction with the treasury advisers, will continually monitor both the prevailing interest rates and the market forecasts, adopting the following responses to a change of sentiment:

if it were felt that there was a significant risk of a sharp FALL in long and short term rates, e.g. due to a marked increase of risks around relapse into recession or of risks of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

if it were felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast, perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

7.4 ***External v. internal borrowing***

TABLE 10 – Comparison of gross and net debt positions at year end	2008/9 £m	2009/10 £m	2010/11 £m	2011/12 £m	2012/13 £m
	Actual	Predicted outturn	estimate	estimate	estimate
Actual external debt	19.281	26.151	32.076	33.774	35.395
Cash Balances and Investments	(3.023)	(6.000)	(5.000)	(5.000)	(5.000)
Net Debt	16.258	20.151	27.076	28.774	30.395

7.5 This Authority currently has a difference between gross debt and net debt (after deducting cash balances and investments), of £6,000m. The general aim of this treasury management strategy is to maintain only prudent levels of cash and investments to ensure sufficient cash is available to fund day-to-day activities of the authority, whilst having regard to the credit risk incurred by holding investments. However, another factor which will be carefully considered is the difference between borrowing rates and investment rates to ensure the Authority obtains value for money once an appropriate level of risk management has been attained to ensure the security of its investments. The next financial year is expected to be one of historically abnormally low Bank Rate. This provides a continuation of the current window of opportunity for local authorities to fundamentally review their strategy of undertaking new external borrowing.

7.6 Over the next three years, investment rates are expected to be below long term borrowing rates and so value for money considerations would indicate that value could best be obtained by avoiding new external borrowing and by using internal cash balances to finance new capital expenditure or to replace maturing external debt (this is referred to as internal borrowing). This would maximise short term savings. However, short term savings by avoiding new long term external borrowing in 2010/11 will also be weighed against the potential for incurring additional long term extra costs by delaying unavoidable new external borrowing until later years when PWLB long term rates are forecast to be significantly higher.

7.7 Against this background caution will be adopted with the 2010/11 treasury operations. The Director of Finance will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to the appropriate decision making body at the next available opportunity.

Policy on borrowing in advance of need

7.8 The Authority will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Authority can ensure the security of such funds.

7.9 In determining whether borrowing will be undertaken in advance of need the Authority will;

- ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to take funding in advance of need
- ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow
- consider the merits and demerits of alternative forms of funding
- consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use.

8. DEBT RESCHEDULING

8.1 The introduction of the new PWLB rates structure on 1 November 2007 that introduced a spread between the rates applied to new borrowing and repayment of debt, has meant that PWLB to PWLB debt restructuring is now much less attractive than before that date. However, significant interest savings may still be achievable through using LOBOs (Lenders Option Borrowers Option) loans and other market loans in rescheduling exercises.

8.2 As short term borrowing rates will be considerably cheaper than longer term rates, there are likely to be significant opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of their short term nature and the likely cost of refinancing those short term loans, once they mature, compared to the current rates of longer term debt in the existing debt portfolio. Any such rescheduling and repayment of debt is likely to cause a flattening of the authority’s maturity profile as in recent years there has been a skew towards longer dated PWLB.

8.3 Consideration will also be given to the potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

8.4 The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings,
- helping to fulfil the adopted borrowing strategy, and
- enhancing the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

8.5 There has been much discussion as to whether the size of spread between long term PWLB repayment and new borrowing rates should be revised (downwards) in order to help local authorities currently dissuaded from using investment cash balances to repay long term borrowing and thereby reduce counterparty and interest rate risk exposure. The DMO / PWLB have issued a consultation document with suggested options to revise the methodology used to calculate the early repayment rate. The consultation period ended in January 2010 and this authority will monitor developments in this area and may amend its strategy if significant changes are introduced.

8.6 All rescheduling will be reported to the Resources Committee, at the earliest meeting following its action.

9. ANNUAL INVESTMENT STRATEGY

Investment Policy

9.1 The Authority will have regard to the CLG's Guidance on Local Government Investments ("the Guidance") issued in March 2004, any revisions to that guidance, the Audit Commission's report on Icelandic investments and the 2009 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Authority's investment priorities are: -

(a) the security of capital and

(b) the liquidity of its investments.

9.2 The Authority will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Authority is low in order to give priority to security of its investments.

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

9.4 Investment instruments identified for use in the financial year are listed in appendix 5 under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Authority's Treasury Management Practices – Schedules.

Creditworthiness Policy

9.5 This Authority uses the creditworthiness service provided by Sector Treasury Services. This service has been progressively enhanced over the last year and now uses a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moodys and Standard and Poors, forming the core element. However, it does not rely solely on the current credit ratings of counterparties but also uses the following as overlays: -

- credit watches and credit outlooks from credit rating agencies

- Credit Default Swap (CDS) spreads to give early warning of likely changes in credit ratings
- sovereign ratings to select counterparties from only the most creditworthy countries

9.6 This modelling approach combines credit ratings, credit watches, credit outlooks and CDS spreads in a weighted scoring system for which the end product is a series of colour code bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Authority to determine the duration for investments and are therefore referred to as durational bands. The Authority is satisfied that this service now gives a much improved level of security for its investments. It is also a service which the Authority would not be able to replicate using in house resources.

9.7 The selection of counterparties with a high level of creditworthiness will be achieved by selection of institutions down to a minimum durational band within Sector's weekly credit list of worldwide potential counterparties.

9.8 This Authority will not use the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine creditworthy counterparties as Moodys are currently very much more aggressive in giving low ratings than the other two agencies. This would therefore be unworkable and leave the Authority with few banks on its approved lending list. The Sector creditworthiness service does though, use ratings from all three agencies, but by using a scoring system, does not give undue preponderance to just one agency's ratings.

9.9 All credit ratings will be monitored weekly. The Authority is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service.

- If a downgrade results in the counterparty/investment scheme no longer meeting the Authority's minimum criteria, its further use as a new investment will be withdrawn immediately.
- In addition to the use of Credit Ratings the Authority will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Authority's lending list.

9.10 Sole reliance will not be placed on the use of this external service. In addition this Authority will also use market data and market information, information on government support for banks and the credit ratings of that government support.
Approved Instruments for Investments

9.11 Investments will only be made with those bodies identified by the authority for its use through the Annual Investment Strategy.

Specified Investments	Non Specified Investments
Deposits with the Debt Management Agency Deposit Facility	
Term Deposits with UK government, UK local authorities, credit rated banks and building societies (including callable deposits and forward deals)	Non credit rated building societies
Banks nationalised by the UK government e.g. Northern Rock	
UK Banks in receipt of financial support from the government (as at March 2009 – Abbey, Barclays, HBOS, Lloyds, TSB, HSBC, Nationwide building society, RBS, Standard Chartered)	

9.12 The Authority has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch Ratings (or equivalent from other agencies if Fitch does not provide).

Investment Strategy

9.13 In-house funds: The Authority's in-house managed funds are mainly cash-flow derived and. Investments will accordingly be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

9.14 Interest rate outlook: Bank Rate has been unchanged at 0.50% since March 2009. Bank Rate is forecast to commence rising in quarter 3 of 2010 and then to rise steadily from thereon. Bank Rate forecasts for financial year ends (March) are as follows: -

2010 0.50%

2011 1.50%

2012 3.50%

2013 4.50%

There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected.

9.15 The Authority will avoid locking into longer term deals while investment rates are down at historically low levels unless exceptionally attractive rates are available which make longer term deals worthwhile.

9.16 For 2010/11 the Authority has budgeted for an investment return of 0.75% on investments placed during the financial year.

End of year investment report

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

Policy on the use of external service providers

9.18 The Authority uses Sector Treasury Services as its external treasury management advisers. The Authority recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

9.19 It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Authority will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

10. MINIMUM REVENUE PROVISION (MRP) STRATEGY

10.1 What is a Minimum Revenue Provision? - Capital expenditure is generally expenditure on assets which have a life expectancy of more than one year e.g. fire stations, vehicles, equipment etc. It would be impractical to charge the entirety of such expenditure to revenue in the year in which it was incurred and so such expenditure is spread over several years so as to try to match the years over which such assets benefit the local community through their useful life. The manner of spreading these costs is through an annual Minimum Revenue Provision, which was previously determined under Regulation, and will in future be determined under Guidance.

10.2 New statutory duty - Statutory Instrument 2008 no. 414 s4 lays down that: “A local authority shall determine for the current financial year an amount of minimum revenue provision that it considers to be prudent.”

10.3 The above is a substitution for the previous requirement to comply with regulation 28 in S.I. 2003 no. 3146 (as amended).There is no requirement to charge MRP where the Capital Financing Requirement is nil or negative at the end of the preceding financial year.

10.4 New Government Guidance - Along with the above duty, the Government issued new guidance in February 2008 which requires that a Statement on the Council’s policy for its annual MRP should be submitted to the full Authority for approval before the start of the financial year to which the provision will relate.

10.5 The Authority are legally obliged to “have regard” to the guidance, which is intended to enable a more flexible approach to assessing the amount of annual provision than was required under the previous statutory requirements. The guidance offers four main options under which MRP could be made, with an overriding recommendation that the Authority should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits. The requirement to ‘have regard’ to the guidance therefore means that: Although four main options are recommended in the guidance, there is no intention to be prescriptive by making these the only methods of charge under which a local authority may consider its MRP to be prudent;

10.6 It is the responsibility of each authority to decide upon the most appropriate method of making a prudent provision, after having had regard to the guidance. The guidance broadly requires authorities to make revenue provision for the repayment of borrowing over a period of time which bears some relation to the finite life of the asset to which borrowing is being taken. There are four options set out in the guidance which are briefly as follows;

For borrowing after 1st April 2008 which is supported by Revenue Support Grant (RSG) and for all borrowing before 1st April 2008;

Option 1 – Regulatory Method

MRP calculated on the basis of the old rules as this is the basis for calculating Revenue Support Grant implications.

Option 2 – CFR Method

MRP can be calculated on the basis of 4% of the CFR at the end of the preceding financial year. If the CFR at that date is nil or negative, no MRP is required.

For new borrowing after 1st April 2008, under the Prudential system and for which no Government support is given;

Option 3 – Asset Life Method

Where capital expenditure on an asset is financed wholly or partly by borrowing or credit arrangements, MRP is to be made in equal annual instalments over the life of the asset. In this circumstance the asset life is to be determined when MRP commences and not changed after that.

MRP should normally commence in the financial year following the one in which the expenditure is incurred. However, when borrowing to construct an asset, the authority may treat the asset life as commencing in the year in which the asset first becomes operational. It may accordingly postpone beginning to make MRP until that year. Investment properties should be regarded as becoming operational when they begin to generate revenues.

Option 4 – Depreciation Method

MRP is to be equal to the provision required in accordance with depreciation accounting in respect of the asset on which expenditure has been financed by borrowing or credit arrangements.

10.7 Whilst options 1 and 2 are available for unsupported borrowing before 1st April 2008, authorities are able to use options 3 and 4 if they choose to do so.

10.8 A draft MRP statement for 2010/2011 is attached as Appendix C for Authority approval. The financing of the approved 2010/2011 capital programme, and the resultant prudential indicators, have been set on the basis of the content of this statement. As highlighted in paragraph 5.2, the proposed prudential indicators do not include any potential changes from the introduction of IFRS or the PFI project at Severn Park, Avonmouth. In the event that these changes impact on the prudential indicators, then it is likely that the MRP Statement will also need to revised through the authority.

11. SUMMARY AND RECOMMENDATIONS

11.1 The authority is required to consider and approve the treasury management strategy to be adopted prior to the start of the financial year. This strategy must also include proposed prudential indicators and a minimum provision statement (MRP). Approval of the strategy for 2010/2011 as contained in this report will also incorporate the adoption of the revised CIPFA Treasury Management Code of Practice in 2009.

KEVIN WOODWARD
Treasurer

APPENDIX A TO REPORT DSFRA/10/3

ADOPTION OF THE REVISED CIPFA TREASURY MANAGEMENT CODE OF PRACTICE 2009

1. INTRODUCTION

1.1 The CIPFA Code of Practice on Treasury Management in Local Authorities was last updated in 2001 and has been revised in 2009 in the light of the default by Icelandic banks in 2008. The revised Code requires that a report be submitted to the authority setting out four amended clauses which should be formally passed in order to approve adoption of the new version of the Code of Practice and Cross-Sectoral Guidance Notes.

1.2 The revised Code also includes an amended version of the treasury management policy statement (TMPS) incorporating just three clauses and a revised definition of treasury management activities. The Code does not require this statement to be approved by the Authority, board or other appropriate body.

2. RESOLUTIONS

2.1 CIPFA recommends that all public service organisations adopt, as part of their standing orders, financial regulations, or other formal policy documents appropriate to their circumstances, the following four clauses.

1. This organisation will create and maintain, as the cornerstones for effective treasury management:

    - a treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities
    - suitable treasury management practices (TMPs), setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

    The current DSFRA Treasury Management Policy document, as revised in March 2009, already includes the requirements of this clause.

2. The full Authority will receive reports on its treasury management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its TMPs.
3. This organisation delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to the Resources Committee, and for the execution and administration of treasury management decisions to the Treasurer, who will act in accordance with the organisation's policy statement and TMPs.
4. This organisation nominates the Resources Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

PRUDENTIAL AND TREASURY INDICATORS

PRUDENTIAL INDICATOR	2010/11 £m estimate	2011/12 £m estimate	2012/13 £m estimate
Capital Expenditure			
Non - HRA	6.847	4.069	4.069
HRA (applies only to housing authorities)	0	0	0
TOTAL	6.847	4.069	4.069
Ratio of financing costs to net revenue stream			
Non - HRA	3.80%	4.38%	4.63%
HRA (applies only to housing authorities)	0%	0%	0%
Capital Financing Requirement as at 31 March			
Non – HRA	32.076	33.774	35.395
HRA (applies only to housing authorities)	0	0	0
TOTAL	32.076	33.774	35.395
Annual change in Cap. Financing Requirement			
Non – HRA	3.561	1.698	1.621
HRA (applies only to housing authorities)	0	0	0
TOTAL	3.561	1.698	1.621
Incremental impact of capital investment decisions	£ p	£ p	£ p
Increase/(decrease) in council tax (band D) per annum	(£0.28)	(£0.17)	(£0.07)
TREASURY MANAGEMENT PRUDENTIAL INDICATORS			
	£000	£000	£000
Authorised Limit for external debt -			
borrowing	38.603	40.190	41.619
other long term liabilities	0	0	0
TOTAL	38.603	40.190	41.619
Operational Boundary for external debt -			
borrowing	35.395	36.813	38.079
other long term liabilities	0	0	0
TOTAL	35.395	36.813	38.079

	upper limit %	lower limit %
Limits on borrowing at fixed interest rates	100%	70%
Limits on borrowing at variable interest rates	30%	0%
Maturity structure of fixed rate borrowing during 2009/10		
Under 12 months	10%	0%
12 months and within 24 months	15%	0%
24 months and within 5 years	30%	0%
5 years and within 10 years	50%	0%
10 years and above	100%	50%

MINIMUM REVENUE STATEMENT (MRP) 2010/2011

Supported Borrowing

The MRP will be calculated using the regulatory method (option 1). MRP will therefore be calculated using the formulae in the old regulations, since future entitlement to RSG in support of this borrowing will continue to be calculated on this basis.

Un-Supported Borrowing (including un-supported borrowing prior to 1st April 2008)

The MRP in respect of unsupported borrowing under the prudential system will be calculated using the asset life method (option 3). The MRP will therefore be calculated to repay the borrowing in equal annual instalments over the life of the class of assets which it is funding. The repayment period of all such borrowing will be calculated when it takes place and will be based on the finite life of the class of asset at that time and will not be changed.

MRP will normally commence in the financial year following the one in which the expenditure was incurred. However, when borrowing to construct an asset, the authority may treat the asset life as commencing in the year in which the asset first becomes operational. It may accordingly postpone the beginning to make MRP until that year. Investment properties will be regarded as becoming operational when they begin to generate revenues.