AGENDA ITEM 11	WEST DEVON BOROUGH COUNCIL	AGENDA ITEM 11

NAME OF COMMITTEE	COUNCIL
DATE	27 MARCH 2012
REPORT TITLE	TREASURY MANAGEMENT STRATEGY FOR 2012/13 TO 2014/15, MINIMUM REVENUE PROVISION POLICY STATEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2012/13
Report of	HEAD OF FINANCE
WARDS AFFECTED	ALL

Summary of report:
This report outlines the Council's treasury indicators for 2012/13 – 2014/15 and sets out the expected treasury operations for this period. This report has been scrutinised by the Audit Committee on 7 February 2012. As a result, an Executive Summary has been prepared on the Treasury Management and Investment Strategy and is provided at the end of this report.

Financial implications:
The primary objective of this strategy would be to maximise the return **on** the Council's investment activities, in proportion with acceptable risk. However we have been in exceptional circumstances with the global economy going through turbulent times, therefore the focus has changed to that of protecting our capital and getting the return **of** the Council's investments.

RECOMMENDATIONS:
The Council is recommended to approve each of the key elements of this report:

1. The Prudential Indicators and Limits for 2012/13 to 2014/15 contained within Appendix A of the report.
2. The Minimum Revenue Provision (MRP) Statement contained within Appendix A which sets out the Council's policy on MRP.
3. The Treasury Management Strategy 2012/13 to 2014/15 and the treasury Prudential Indicators contained within Appendix B.
4. The Investment Strategy 2012/13 contained in the treasury management strategy (Appendix B), and the detailed criteria included in Appendix C.

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1. BACKGROUND

1.1 The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

1.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.3 CIPFA defines treasury management as:

'The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of risks associated with those activities; and the pursuit of optimum performance consistent with those risks.'

2. REPORTING REQUIREMENTS

2.1 The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals. These reports are required to be adequately scrutinised by Committee before being recommended to Council. This role is undertaken by the Audit Committee.

Prudential and Treasury indicators and Treasury Strategy (this report) – The first and most important covers:

- The capital plans (including prudential indicators);
- A Minimum Revenue Provision Policy (how residual capital expenditure is charged to revenue over time)
- The Treasury Management Strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- An Investment Strategy (the parameters on how investments are to be managed).

A Mid Year Treasury Management Report – This will update members on whether the treasury function is meeting the strategy or whether any policies require revision.

An Annual Treasury Report – This provides details of the treasury indicators and actual treasury operations compared to the estimates within the strategy.

3. TREASURY MANAGEMENT FOR 2012/13

The strategy for 2012/13 covers two main areas:

3.1 Capital Issues

- The capital plans and the prudential indicators
- The MRP strategy

3.2 Treasury management issues:

- The current treasury position
- Treasury indicators which will limit the treasury risk and activities of the Council
- Prospects for interest rates
- The borrowing strategy
- Policy on borrowing in advance of need
- Debt rescheduling
- The investment strategy
- Creditworthiness policy; and
- Policy on use of external service providers

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the CLG MRP Guidance, the CIPFA Treasury Management Code and the CLG Investment Guidance.

4. LEGAL IMPLICATIONS

4.1 The CIPFA Code of Practice states that Members receive and adequately scrutinise the treasury management service. The Council nominated the Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies. This was agreed at Council on 25th February 2010 and formed part of the revision to the Council's Constitution in April 2010.

5. FINANCIAL IMPLICATIONS

5.1 In 'general' economic conditions, the primary objective would be to maximise the return on the Council's investment activities, in proportion with acceptable risk. Effective treasury management strives to maximise investment returns whilst minimising risk and protecting capital. However we have been through exceptional circumstances, therefore the focus has changed to that of protecting our capital and getting the return of the Council's investments.

5.2 The unprecedented financial crisis has resulted in significant interest cuts around the world and interest rates are currently at a record low level with the bank base rate at 0.5%. This, coupled with adopting a near risk free investment strategy, has meant a significant drop in the level of investment income that supports the revenue budget. To illustrate how falling interest rates are affecting the Council, in 2007/08 we had investment income of £720,000. For 2012/13 it is estimated to be £65,000, a reduction of £655,000 since 2007/08.

6. RISK MANAGEMENT

6.1 The risk management implications are:

Opportunities	Benefits
For the Council to comply with all of the above relevant statutory and regulatory requirements which limit the levels of risk associated with its treasury management activities.	The Council's adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrates a low risk approach. The Council has utilised low borrowing costs and has complied with its internal and external procedural requirements. There is no risk of volatility of costs in the current debt portfolio as the interest rates are fixed, utilising long-term loans.
Issues/Obstacles/Threats	**Control measures/mitigation**
The Council is aware of the risks of passive management of the treasury portfolio and, with the support of the Council's advisers, has proactively managed its treasury position. Shorter-term rates and likely future movements in these rates predominantly determine the Council's investment return. These returns can therefore be volatile and, whilst the risk of loss of principal is minimised through the annual investment strategy, accurately forecasting future returns can be difficult.	The Council has adopted the CIPFA Code Of Practice for Treasury Management and produces an annual Treasury Management Strategy and Investment Strategy in accordance with Government guidelines. The Council uses a Treasury Management advisor and a prudent view is always taken regarding future interest rate movements. Investment interest income is reported to the Audit Committee. The Council continues to maintain investments short term with high quality counterparties.

Corporate priorities engaged:	The report meets all of the corporate priorities
Statutory powers:	See legal implications above
Considerations of equality and human rights:	N/A
Biodiversity considerations:	N/A
Sustainability considerations:	N/A
Crime and disorder implications:	N/A
Background papers:	Treasury Management and Investment Strategy for 2011/12 to 2013/14 Treasury Management Monitoring – April to September 2011

	Capital Programme 2010/11 and Prudential Indicators for 2011/12
Appendices attached:	Appendix A – The Capital Prudential Indicators Appendix B - Treasury Management Strategy 2012/13 – 2014/15 Appendix C -Treasury Management Practice (TMP) 1 – Credit and Counterparty Risk Management Appendix D – Treasury Management Scheme of delegation

Treasury Management and Investment Strategy – Executive Summary

Treasury management is defined as:

> 'The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks .'

The original strategy for 2011/12 allowed the use of Eligible Institutions. The government announced under the credit guarantee scheme this is no longer available. Sectors view as an alternative is to consider the use of part nationalised banks (Lloyds and RBS), their position is as follows;

1. They are both nationalised with government holdings of approximately 82% (RBS) and 41% (Lloyds).
2. This does not mean there is a government guarantee, merely that the government has material holdings in the banks which have been created using public funds.
3. Sectors view is that these holdings give investors increased levels of comfort that, in the event of a threat of default, the Government would look to safeguard taxpayers' money.
4. The Moody's rating changes recently included RBS and Lloyds in the top tier with regards to likelihood of systematic support (if required).

The current strategy allows for investments to be made for over 3 months for all counterparties that meet the credit rating criteria. We are recommending that in the current economic climate and the heightened credit concerns it is considered appropriate to keep investments short term with a maximum duration of 3 months.

This limit will apply to all entities on the suggested counterparty list with the following exceptions:

1. UK Government and related entities such as Local Authorities. The duration limit will remain at 1 year.
2. UK semi-nationalised institutions (Lloyds/RBS). The Council continue to view the current significant UK ownership of these entities as providing significant comfort.
3. Money Market Funds. The duration of investments will remain with no time limit.

Creditworthiness Policy

This Council applies the creditworthiness service provided by Sector. This service employs a sophisticated modelling approach utlilising credit ratings from the three main credit rating agencies - Fitch, Moodys and Standard and Poors. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies;CDS spreads to give early warning of likely changes in credit ratings; sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the duration for investments. The Council will therefore use counterparties within the following durational bands:

- Yellow 5 years
- Purple 2 years
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 3 months
- No Colour not to be used

The Sector creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

If the Council agrees to adopt the Sector creditworthiness policy, this would currently have the effect of allowing the Council to invest with counterparties such as Barclays Bank plc and the Nationwide Building Society.

All credit ratings will be monitored weekly. The Council 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 Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of credit ratings the Council will be advised of information 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 Council's lending list.

A Guide to Money Market Funds	
Definition	A pool of cash managed by an independent fund management company. Frequently these are well known banks or investment houses
Investment	Investors purchase units (shares) of the fund which are held on their behalf in a custody account.
Returns	Returns in line with either 7-day or 1-month LIBID are targeted by most funds.

Liquidity	The funds are very liquid. Shares can be purchased and sold on the same day if necessary and without penalty. Deals are subject to a cut-off time which varies from manager to manager but can be as late as 2pm.
Variety	Two types of classes exist – 1) Stable Net Asset Value (SNAV) – the most common variety. Prices are fixed and interest is credited to investors in the form of a dividend. 2) Accumulating Net Asset Value (ANAV) – interest is credited to the shares and the price rises to reflect the return achieved.
Accounting	Purchases of MMF shares do not score as capital expenditure. Sales do not score as capital receipts.
Legality	Local authorities are permitted to invest in sterling denominated funds with a AAA credit rating and domiciled in the EU.
Regulation	UK-based Funds are regulated by the Financial Services Authority. Those domiciled in other EU zones (the majority) are regulated via the Undertakings for Collective Investment in Transferable Securities (UCITS) Code. The Code lays down strict common standards of investment and management.
Portfolio holdings	Cash is invested in a selection of high quality, high liquidity securities including: time deposits, certificates of deposit, short-dated gilts, corporate bonds and notes, commercial paper etc.
Credit rating	Local authorities are empowered to place funds in investment schemes with a high credit rating. Money Market Funds fall into this category and are all rated by one or more of the three rating agencies. Credit Quality – measures the financial strength of the fund (not the manager) and the probability of it defaulting.
Risk management	The funds eligible for local authority investment score highly on credit quality and low volatility. All have a AAA rating which means that the chances of default are considered minimal. 1) Rating requirements – in order to maintain a AAA rating fund managers must adhere to requirements specified by the rating agencies. These include:

Exposure limits	• A maximum exposure to any one counterparty (concentration ratio) between 5% & 10% • A maximum weighted average maturity (WAM) for the entire fund – typically 60 days • A minimum level of overnight investments to ensure high liquidity • A lower limit on quality of investment counterparty 2) Ring fencing – monies received from share purchases are invested in financial instruments by the managing organisation. Deposits/security investments are held in custody by a non-related company that specialises in custody services. Counterparty exposure of the fund (and of the investor) is to the underlying securities and not to the management company. In view of the funds' low concentration ratios; quality of asset holdings; maximum WAM and ring-fencing arrangements, counterparty risk is spread widely. MMF's possess the same status as external fund managers operating cash/gilt funds for local authorities. They should have their own counterparty limit which can be considerably greater than that accorded to individual investment counterparties.