South Bucks District Council

Treasury Management Strategy 2012/2013

1. Background

1.1. The Council adopted the CIPFA code of practice on Treasury Management in June 2002, which includes the creation of a Treasury Management Strategy, which sets out the policies, and objectives of the Council's treasury management activities for the year ahead.

1.2. In the light of the Icelandic situation in 2008,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 that the Council formally adopt the Code which it did on 23rd February 2010. For Members information the requirements of the Code are detailed below.

1.3 The revised Code is built largely on what was recommended practise in the previous version, but does place greater or new emphasis in certain key areas. The main points in the new Code are as follows:-

a) All councils must formally adopt the revised Code and four clauses, these are shown as at appendix A which also sets out the scheme of delegation and the treasury management role of the section 151 officer.

b) The strategy report will affirm that the effective management and control of risk are prime objectives of the Council's treasury management activities. This is consistent with the approach always adopted by this Council.

c) The Council'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. This is something the Council has always been very clear about, in that whilst it uses advisers and external sources of information, that it is the officers and members of the authority who are accountable for policy and decisions.

e) Credit ratings should 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 credit ratings of that government support.

f) Councils need a sound diversification policy with high 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. As a debt free authority this is not an issue that arises for the Council.

h) The main annual treasury management reports must be approved by full council.

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. For South Bucks DC this requirement is met by the regular reports to the Resources Portfolio Holder.

j) Each council must delegate the role of scrutiny of treasury management strategy and policies to a specific named body. For South Bucks DC this is carried out by the Resources PAG.

k) Treasury Management performance and policy setting should be subjected to prior scrutiny. This is achieved via the regular discussions on Treasury Management at the RPAG.

l) Members should be provided with access to relevant training e.g. the session that was run in November 2011 in conjunction with the Council's Treasury Management advisers and was open to all members of the Council to attend.

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 Council (this will form part of the updated Treasury Management Practices).

1.4 This strategy statement has been prepared in accordance with the revised Code. As in previous years the Council's Treasury Management Strategy will be approved annually by the full Council. In addition there will also be quarterly monitoring reports to the Resources PAG one of which will be the annual report. In addition the Resources Portfolio Holder will be emailed each month with a spreadsheet showing where the Council's investment portfolio has been invested. 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 those implementing policies and executing transactions have properly fulfilled their responsibilities with regard to delegation and reporting.

1.5 The Council will adopt/reaffirm the following reporting arrangements in accordance with the requirements of the revised Code:-

Area of Responsibility	Reporting Arrangements	Frequency
Treasury Management Policy (revised)	Resources PAG /Cabinet/Council	Initial adoption 2010
Treasury Management Strategy Annual Investment Strategy MRP policy	Resources PAG /Cabinet/Council	Annually before the start of the year
Treasury Management Strategy Annual Investment Strategy MRP policy – mid year report	Resources PAG /Cabinet/Council	Appropriate quarterly report to RPAG
Treasury Management Strategy Annual Investment Strategy MRP policy – updates or revisions at other times	Resources PAG /Cabinet/Council	As appropriate
Annual Treasury Outturn Report	Resources PAG /Cabinet/Council	Annually by 30 September after the end of the year
Monitoring Reports	Resources PAG /Cabinet/Council	Quarterly
Treasury Management Practices	Resources PAG /Cabinet/Council	Annually
Investment Portfolio Detail	Resources Portfolio Holder	Monthly
Scrutiny of treasury management strategies & performance	Resources PAG	Ongoing but with particular focus when considering annual Strategy

1.6. The Local Government Act 2003 and supporting regulations requires the Council 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 Council's capital investments plans are affordable, prudent and sustainable.

1.7. The Act requires the Council to set out its Treasury Strategy and to prepare an Annual Investment Strategy which sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

1.8. It is a statutory requirement under section 33 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular, section 32 requires a local authority to calculate its budget requirements 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 revenues from :

- Loss of investment interest caused by the use of capital receipts to finance additional capital expenditure.

- Any increases in running costs from new capital projects.

are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

1.9. The DCLG's investment guidance states that authorities could combine the Treasury Strategy Statement and the Annual Investment Strategy (AIS) into one report and the AIS supporting this Strategy Statement is attached as Appendix B.

1.10. Following discussions with Sector Treasury Services, the Council's treasury management advisors, the proposed target figure for investment returns for 2012/2013 is £800,000.

1.11. This Strategy seeks approval for this level of return, how realistic it is and sets out how it can be achieved.

2. Current Portfolio Position

2.1. Investment Criteria – Investment income is mainly generated by Officers placing money in callable or fixed deposits with approved counter parties. When making the decision to invest Officers take into account security, liquidity and yield which are inter-related and the balance of the three is determined by the authority's needs and risk appetite. Decisions to invest are made following discussion between the Director of Resources and the Principal Accountant both of whom have been involved in treasury management for many years. The discussion on investment is based upon information that is available from the Council's treasury consultants, Sector, and brokers acting in the local authority money market, combined with general intelligence available from money market briefings made available to the authority. Members approved a new matrix for in house investments made by Officers as part of the Treasury Management Strategy 2010/11 as follows:

2.2.

	Fitch Credit Rating	Maximum Amount	Comment
	AAA	£10 million	The durations of the

UK Institutions	AA+ or AA-	£7 million*	investment would be informed by the detailed credit rating information
	A to A+	£1 million	
Non UK Institutions	AA or better	£2 million	As above but also sovereignty rating must be AAA
Corporate Bonds	AA or better	£2 million	Investment decision will be based on balancing yield against duration

* Members agreed that for RBS only this limit is increased to £10 million whist the bank substantially remained in state ownership.

** As part of the Council's Treasury Management Strategy 2011/12 Members agreed to add the Co-operative Bank (A-) with a limit of £1 million, on the basis of the competitive rates it currently offers.

In October the rating agency Fitch revised downward to A the credit rating of most of the UK banks with the exception of Barclays, HSBC and Santander UK. The change reflects Fitch's view that support dynamics are changing in the UK. The banking system is not only large relative to the UK economy, but there is also more advanced political will to reduce the implicit support for the country's banks, building on The Banking Act 2009 and, more recently the various policy recommendations of the Independent Commission on Banking (ICB). Fitch believes that support for these banks is likely to remain high until elements of the UK banking sector complete their rehabilitation and some of the more practical aspects of bank resolution can be implemented. There is also the potential for the provision of extraordinary support for senior bank creditors to be relatively less certain than before. For Lloyds Banking Group (LBS) and Royal Bank of Scotland Group (RBSG) both of these banking groups have shown steady improvement in their risk profiles and prospects over the past two years and, assuming there is no major fallout from the euro zone crisis, for example, ought to be able to achieve higher ratings over the medium and long term.

This rating change would mean that as things stand the Council would have to significantly reduce its investments with most of the major UK as investments mature. It would also be faced with having a very limited range of counterparties to place funds of more than £1m with. The Council will not have to address this issue until 2012/13, as there is no suggestion that any of these banks are danger of default. This Treasury Management Strategy for 2012/13 contains a proposed revision of the counterparty matrix for Members approval in 4.6 below.

2.3 A summary of the Council's current holdings of fixed deposits is shown below:

UK Institutions	Fitch Credit Rating	Maximum Amount £7 Million Principal £	Interest Rate	Invested	Matures	Notes
Royal Bank of Scotland	A					
Fixed Deposit		5,000,000	4.25%	08/02/11	08/02/16	(1)
Fixed Deposit		2,000,000	2.50%	02/06/11	02/06/14	(2)
Total RBS		7,000,000				
Cater Allen	A+					
Fixed Deposit		1,000,000	2.50%	03/10/11	03/10/12	
Fixed Deposit		1,000,000	3.50%	21/07/10	21/07/13	
Fixed Deposit		2,000,000	3.20%	30/09/10	30/09/13	
Fixed Deposit		1,000,000	2.50%	02/11/11	02/11/12	
Fixed Deposit		2,000,000	2.50%	16/11/11	16/11/12	

UK Institutions	Fitch Credit Rating	Maximum Amount £7 Million Principal £	Interest Rate	Invested	Matures	Notes
Total CA		7,000,000				
Lloyds Bank	A					
Fixed Deposit		1,000,000	3 Month Libor, Floor 2.85%, Cap 5.85%	11/05/10	11/05/15	
Fixed Deposit		1,000,000	3 Month Libor, Floor 3.07%, Cap 5.00%	19/05/10	19/05/15	
Bank of Scotland	A					
Fixed Deposit		3,000,000	2.10%	15/07/11	16/07/12	
Fixed Deposit		1,000,000	2.10%	04/10/11	04/10/12	
Fixed Deposit		1,000,000	2.05%	14/02/11	14/02/12	
Total Lloyds Group		7,000,000				
Barclays	AA-					
Fixed Deposit		1,000,000	3 Month Libor, Floor 3.05%, Cap 5.00%	24/05/10	26/05/15	
Fixed Deposit		1,000,000	1.415%	15/04/11	15/02/12	
Total Barclays		2,000,000				
Clydesdale	A+					
Fixed Deposit		1,000,000	1.25%	19/04/11	19/01/12	
Total Clydesdale		1,000,000				
Co-operative Bank	A-					
Fixed Deposit		1,000,000	2.50%	14/02/11	14/02/12	
Total Co-op Bank		1,000,000				
Total Deposits		25,000,000				

(1) RBS have the option to switch to 3 month LIBOR[1] plus 30 basis points in years 3, 4 & 5.

(2) RBS have the option to switch to 3 month LIBOR 2 & 3.

In addition the Officers invest short term cash flow. Short term reserves are required mainly in the last quarter of the year when council tax and grant payments tail off but precept payments continue.

3. Prospects for Interest Rates and Economic Background

3.1 Part of the service provided by the Council's treasury management advisers is to assist the Council to formulate a view on interest rates. Appendix C draws together a number of current forecasts for short term (the Bank Rate) and longer fixed interest rates. The following table gives the Sector central view on the bank rate and short term money rates.

	2012				2013				2014	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%
3 Month	0.70%	0.70%	0.70%	0.70%	0.75%	0.80%	0.90%	1.20%	1.40%	1.60%
1 Year	1.50%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.20%	2.40%	2.60%

A detailed view of the current economic background is shown in appendix D with the Sector view shown below.

[1] LIBOR – London Inter Bank Offered Rate

3.2 Sector's View

Growth in the UK economy is expected to be weak in the next two years and there is a risk of a technical recession (i.e. two quarters of negative growth). Bank Rate, currently 0.5%, underpins investment returns and is not expected to start increasing until quarter 3 of 2013 despite inflation currently being well above the Monetary Policy Committee inflation target. Hopes for an export led recovery appear likely to be disappointed due to the Eurozone sovereign debt crisis depressing growth in the UK's biggest export market. The Comprehensive Spending Review, which seeks to reduce the UK's annual fiscal deficit, will also depress growth during the next few years.

Fixed interest borrowing rates are based on UK gilt yields. The outlook for borrowing rates is currently much more difficult to predict. The UK total national debt is forecast to continue rising until 2015/16; the consequent increase in gilt issuance is therefore expected to be reflected in an increase in gilt yields over this period. However, gilt yields are currently at historically low levels due to investor concerns over Eurozone sovereign debt and have been subject to exceptionally high levels of volatility as events in the Eurozone debt crisis have evolved.

This challenging and uncertain economic outlook has a several key treasury mangement implications:

- The Eurozone sovereign debt difficulties, most evident in Greece, provide a clear indication of much higher counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2012/13;
- Borrowing interest rates are currently attractive, but may remain low for some time. The timing of any borrowing will need to be monitored carefully;
- There will remain a cost of capital – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

4 Achieving the investment target in 2012/13

4.1 As illustrated in the interest rate forecasts in 3.1 above and in appendix C there is no increase anticipated in the bank rate until the third quarter of 2013 and investment returns are therefore likely to remain low for the whole of 2012/13.

4.2 Members agreed as part of the Treasury Management Strategy 2010/11 to cease using the services of a cash fund manager, Investec, and the Council's cash investments are managed in house by Officers.

4.3 There is a core amount of cash (£20 million) that forms the Council's investment portfolio. This amount has mainly been built up from the major capital receipts that the authority has received over a number of years from the disposal of assets including the transfer of the Housing Stock, the disposal of the former offices at Windsor Road Slough and the sale of Bells Hill Green. In addition there are revenue reserves & balances and short term cash flow that are available for investment until such time as the cash is required.

4.4 The Treasury Management Code of Practice sets out three important principles:

- Security of Capital
- Liquidity
- A return consistent with these principles.

This Strategy considers how to achieve the investment return in 2012/13 taking the above into account.

4.5 As detailed in 2.1 above due to the recent downgrading of a number of UK banks by the credit rating agencies (including Fitch which the Council uses) means that the current counterparty matrix no longer reflects our current investment portfolio and continuing with the matrix in its current form would mean having to accept lower returns and raise issues of identifying sufficient number of acceptable counterparties to meet the Council's requirements.

4.6 Therefore a revised matrix is proposed. As stated in 2.1 Fitch's view is that the change reflects that support dynamics are changing within the UK building on the changes in The Banking Act 2009 and the recent policy recommendations of the Independent Commission on Banking. It is Fitch's belief that support for these banks will remain high until elements of the banking sector complete their rehabilitation and some of the more practical aspects can be implemented. The banks with a high level of Government support i.e. Lloyds Banking Group and Royal Bank of Scotland Group have shown steady improvement in their risk profiles and prospects of since 2009 and ought to be able to able to achieve higher credit ratings over the medium and long term. Taking this into account a revised counterparty matrix for 2012/13 could be:

	Fitch Credit Rating	Maximum Amount	Comment
UK Institutions	AAA	£10 million	The durations of the investment would be informed by the detailed credit rating information
	A+ or better	£7 million	
	A or better Banks with high UK Gov Support	£7 million	
	A-	£2 million	
Non UK Institutions	AA or better	£2 million	As above but also sovereignty rating must be AAA
Corporate Bonds	AA- or better	£2 million	Investment decision will be based on balancing yield against duration

4.7 The Council's current core investment portfolio has diversification and is split between short term investments of up to one year (35%), and those with a longer duration of between three and five years (65%). Investing an element of the portfolio with a longer duration than some other local authorities has given the Council a better return on its investment (2.39% at October 2011) than others are achieving. However the longer duration element of the portfolio should not be extended any further as it is important in the current climate not to expose all of the portfolio for a long duration and to keep both liquidity/cash available to take advantage of any investment opportunities that may arise and when interest do begin to rise from their current low level.

4.8 In 2012/13 there are five fixed investments totalling £8 million that mature between July and November 2012 which are currently achieving interest rates of either 2.10% or 2.50% and consideration needs to be given to what options are available for reinvestment.

4.9 The decision to reinvest will be dependant on what is available at the time of maturity and will take into account risk verses return duration and liquidity. With no increase in interest rates forecast until the second half of 2013 the period of reinvestment is likely to be short. Currently one year rates are around the levels of the maturing investment, rates for shorter periods of say three months are much lower as illustrated in the forecast in appendix C, indeed the rate for three month money is less than the base plus 60 basis points (1.10%)

that Officers have negotiated with our bankers, Nat West, for 30 days notice money. One other option that could be considered at the time of reinvestment is Corporate Bonds which are discussed below.

4.10 Corporate Bonds - Members last looked at the issue of Corporate Bonds as part of the Treasury Management Strategy 2009/10 and as a result added them to the counterparty matrix although no suitable bond has been found in which to invest since that time.

4.11 When looking at corporate bonds it is important not just to look at the coupon rate(interest rate) available but to consider the accounting treatment for such investments, which is as follows:

- Interest received adjusted to take account of any premium or discount paid by the authority, is credited to the revenue account. In accounting terms it is the effective interest rate that determines what is credited to the revenue account, not the nominal (coupon) interest rate or the gross yield.

- The value of the bond is shown in the balance sheet, including any premium or discount from the nominal value at the time of purchase. At the end of each year the market value of the bond is established and any variance from the net value shown in the balance sheet is then reflected in the balance sheet, but does not impact on the revenue account.

This arrangement would continue throughout the life of the bond provided the bond is not sold. Appendix E illustrates the accounting treatment for examples of bonds purchased with a discount or a premium. What this example indicates is that it is important to make any decision in the light of the actual impact on the authority's accounts taking into account the accounting requirements for local authorities when acquiring financial instruments.

If however the bond is sold prior to maturity then profit or loss on the sale of the bond compared to the balance sheet value is reflected in the revenue account.

4.12 Therefore when considering investment in corporate bonds there is a strategic decision that has to be made i.e.

- whether generally they are to be held to maturity for purposes of obtaining a known level of interest , or

- whether they may be traded in the hope of achieving profits, but therefore accepting the risk of losses. When local authorities follow this option they will use fund managers who have the expertise to trade in bonds, for which they will charge a fee.

4.13 I have spoken to the Council's Treasury Management advisors Sector and they have advised that if the Council wants to achieve the returns currently obtained from cash deposits, they may need to invest for long periods and hold to maturity. Their view is also that with the price of bonds currently high the opportunities to make gain by buying and selling at a profit are limited. Current examples of corporate bonds that meet the revised counterparty matrix and are equivalent to current cash returns will be provided by Sector and circulated prior to the meeting of this Pag.

4.14 When maturities of investments take place corporate bonds could be considered as an instrument for reinvestment in line with the criteria set out in the investment policy. However the amortised cost and effective interest rate calculations would need to be made to ensure that the true revenue return is known for comparison with reinvesting in cash this information will be proved to the Resources Portfolio Holder at the time reinvestment is made. If the Council decided to invest in a corporate bond it has an arrangement with an appropriate financial institution to arrange the investment and wouldn't require the services of a fund manager. As part of the Treasury Management Strategy 2010/11 Members decided to cease using the services of a fund manager (Investec) and for Officers to manage cash investments in – house. The Council could decide to employ the services of a fund manager again who may be able to add capital appreciation trading in gilts and bonds this would be at the risk that there could be capital losses in trading. The employment of a fund manager would require a management fee and there would be a requirement of a minimum investment level which would be above £5 million and more likely is in the range of £10 million.

4.15 Taking into account all of the above factors a reasonable forecast for investment income for 2012/13 is £800,000. This figure is realistic and achievable but is predicated on the assumption that the reinvestment of investments will be able to achieve a rate equal to that of the maturing investments. Loss of £35,000 of investment income is equal to £1 council tax on a band D property.

5 Stoke Poges Memorial Gardens Fund

5.1 The investment returns from the fund is no longer credited directly to the Stoke Poges Memorial Gardens Fund cost centre but has been incorporated with all of the Council's other investment returns.

5.2 Due to the current cost of buying a new bond it is current policy to reinvest any maturities within the Council's cash investments. There is one maturity of £210,000 from the Stoke Poges Memorial Gardens Fund in 2012/13. The current market value of the fund is £1,550,175.

6 Financial Summary & Risks

6.1 The budget for investment interest was set as £900,000 for 2011/12.Current estimated returns show that there is likely an underachievement for the year of £17,000.

6.2 For 2012/13 investment income will be based on total core cash reserves of £20m in line with the medium term financial strategy. In addition officers invest surplus cash flow during the year and estimated returns are based on short-term interest rates remaining within the range of 0.50% to 1.10%.

6.3 Based upon the recommended Strategy outlined above the estimated investment returns for 2012/2013 are as follows:

	£'000
Fixed Deposits	657
SPMG Bonds & Gilts	66
Short Term Cash Flow	53
Paper Sort Facility Loan £300K @8%	24
Net Total Investment Income	800

6.4 This target for investment income reflects the latest forecasts for interest rates. It is regarded as realistic and achievable, but is predicated on the assumption that the reinvestment of investments will be able to achieve a rate equal to that of the maturing investments. Loss of £35,000 of investment income is equal to £1 council tax on a band D property.

6.5 As stated the investment returns are based upon a level of balances for 2012/13 of £20m. The estimated capital programme shows that this is realistic based on the latest programme. It is because of the level of capital receipts that the Council hold that it will remain a debt free authority.

6.6 As with any budgets based on forecasts of future interest rates there is a risk of variation due to factors outside of the Council's control. This risk will need to be taken into account in determining the level of reserves held by the authority.

6.7 The Local Government Act 2003 sets out the new capital regulations and specifies that local authorities must comply with the Prudential Code produced by CIPFA. The Council has a duty to determine an affordable borrowing limit. As a debt free authority this would be nil, however the regulations also incorporate the limit for temporary borrowing required to cover short term cash flow. Whilst the Council has not needed to undertake any temporary borrowing since 1990/1991 it is necessary under statute to approve a limit in case the circumstances arise should it be required. It is recommend that Members approve an authorised borrowing limit of £3.5 million and an operational borrowing limit of £3 million, these together with other prudential indicators that the Council are required to set under the code are shown at Appendix F.

<u>Appendices</u>

A – Revised Policy Statements and CIPFA Code

B – Annual Investment Strategy

C – Interest Rate Forecasts

D – Economic Background

E – Example of Corporate Bond Accounting Treatment

F – Prudential Indicators

G – Minimum Revenue Provision