PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT STRATEGY 2012/13- 2016/17

KEY ISSUE/DECISION:

To set the Council's prudential indicators for 2012/13 to 2016/17, approve the Minimum Revenue Provision (MRP) Policy for 2012/13 and agree the Treasury Management Strategy for 2012/13.

BACKGROUND:

1. Since 1 April 2004 Treasury Management investment controls have been regulated through official guidance originally issued by the then Office of the Deputy Prime Minister (ODPM) under section 15(1)(a) of the Local Government Act 2003. In response to the Icelandic banking crisis and recommendations made by the Audit Commission in the report 'Risk and Return', the Chartered Institute for Public Finance and Accountancy (CIPFA) issued a revised Treasury Management Code in 2009, which gives greater emphasis on the scrutiny of treasury management practices. The purpose of this report is to outline the Council's prudential indicators for 2012/13 – 2016/17 and sets out the expected treasury operations for this period. It fulfils four key legislative requirements:

   - The reporting of the prudential indicators setting out the expected capital activities (as required by the CIPFA Prudential Code for Capital Finance in Local Authorities). The treasury management prudential indicators are now included as treasury indicators in the CIPFA Treasury Management Code of Practice;
   - The reporting of the Council's Minimum Revenue Provision (MRP) Policy, which sets out how the Council will pay for capital assets through revenue each year (as required by Regulation under the Local Government and Public Involvement in Health Act);
   - The reporting of the Council's treasury management strategy statement, which sets out how the Council's treasury function will support the capital expenditure decisions taken in line with the MRP policy, the day to day operation of treasury management and the limitations on treasury activity as defined in treasury prudential indicators. The key indicator is the Authorised Limit: the maximum amount of debt the Council could afford to service in the short term, but which would not be sustainable in the longer term. This is the Affordable Borrowing Limit required by s3 of the Local Government Act 2003. This is in accordance with the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code;
   - The reporting of the Council's investment strategy, which sets out the criteria for choosing investment counterparties and how the exposure to the risk of loss will be limited. This strategy is in accordance with the investment guidance issued by the Department for Communities and Local Government (CLG).

2. The above policies and parameters provide an approved framework within which the

officers undertake the day-to-day capital and treasury activities. The content of this report is highly technical but it is a statutory requirement for the Full Council to consider the content of the report.

RECOMMENDATIONS:

3. The Council is recommended to approve each of these four key elements of the report:

- The prudential indicators and limits (including the authorised limit) for 2012/13 - 2016/17.
- The Minimum Revenue Provision (MRP) Statement, which sets out the Council's policy on MRP.
- The treasury management strategy 2012/13, and the treasury prudential indicators 2012/13-2016/17.
- The investment limits for 2012/13 as contained in the treasury management strategy and the detailed criteria included in Appendices 1 and 2.

CAPITAL PRUDENTIAL INDICATORS 2012/2013 – 2016/17

The prudential code

4. The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. This report revises the indicators for 2012/13 – 2016/17. Each indicator either summarises the expected activity or introduces limits upon the activity, and reflects the outcome of the Council's underlying capital appraisal system.

5. Within this overall prudential framework there is a clear impact on the Council's treasury management function, either through borrowing or investment activity. As a consequence, the Treasury Management Strategy for 2012/13 is included in this report to complement the indicators. This report also includes the prudential indicators relating to the treasury activity.

Capital expenditure

6. The Council's capital expenditure plans are summarised below, and form the first of the Prudential Indicators. Total capital expenditure is partially funded by resources such as capital receipts and capital grants. Any remaining expenditure, which cannot be immediately funded from other resources, will form a need to borrow. A breakdown of the funding proposed for the capital budget is detailed in the main budget report, and summarised in table 1.

7. A certain level of capital expenditure will be supported by government grants; anything above this level will be unsupported and must be paid for from the Council's own resources. Since 2006/07 Surrey County Council has not received revenue funding for the Supported Capital Expenditure SCE(R) element of government allocations. The effect of this is that any borrowing undertaken in relation to these allocations will have a direct impact on the level of Council Tax.

8. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although no control has yet been required.

9. The key risks to the plans are that the future level of Government support has been estimated and therefore may be subject to change. Similarly some estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale. Anticipated asset sales may be postponed due to the impact of the credit crisis on the property market.

10. Capital expenditure and sources of funding during 2010/11 and the estimated figures for the period 2011/12 to 2016/17 are shown in table 1.

11. The Council is asked to approve the summary capital projections in table 1 below, which are also contained within the main budget report and Annex 4 to the budget report.

Table 1: Actual and estimated capital expenditure 2010/11 - 2016/17

	2010/11 Actual £m	2011/12 Projected £m	2012/13 £m	2013/14 £m	2014/15 Estimated £m	2015/16 £m	2016/17 £m
Capital Expenditure	105	145	141	150	131	137	122
Financed By:							
Government Grants	54	84	75	74	75	73	74
Capital Receipts	5	22	18	8	15	17	11
Revenue, reserves and third party contributions	16	25	16	4	5	8	11
Net Financing Need for the Year*	**30**	**14**	**32**	**64**	**36**	**39**	**26**

*Capital Expenditure to be met by borrowing

Borrowing requirement (Capital Financing Requirement) and MRP Policy

12. As shown in table 1, part of the capital programme will be financed directly: through, for example, government grants, capital receipts and reserves. Any expenditure that cannot be funded from other resources will increase the Council's external borrowing requirement, known as the Capital Financing Requirement (CFR). The CFR is reduced each year by a statutory revenue charge for the repayment of debt, known as the Minimum Revenue Provision (MRP).

13. The second Prudential Indicator is the Council's Capital Financing Requirement (CFR). The CFR is the total outstanding capital expenditure, which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. The capital expenditure identified in table 1, which will not be funded from existing resources, will increase the CFR.

14. The Council is also required to set aside an amount from revenue each year to provide for the eventual financing of capital expenditure which is not funded from a cash backed resource. This amount is the Minimum Revenue Provision (MRP), although the Council is also allowed to undertake additional voluntary payments.

15. Regulations were issued in 2008 that require Full Council to approve an MRP Statement in advance of each year and which provided a variety of options to replace the previous regulations, so long as there is a prudent MRP provision. The Council is recommended

to approve the following MRP statements:

- For capital expenditure incurred before 1 April 2008, or which in the future will be supported capital expenditure, the MRP policy will be to set MRP at 5% of the Council's CFR.

- From 1 April 2008 for all unsupported borrowing the MRP policy will be the Asset Life Method – MRP will be based on the estimated life of the assets purchased from unsupported borrowing.

16. The Council is asked to approve the CFR projections in table 2:

Table 2: Capital financing requirement 2010/11 - 2016/17

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
	Actual £m	Projected £m	£m	£m	Estimated £m	£m	£m
Opening CFR	521	538	546	572	629	653	679
Add new borrowing:							
MRP and other financing movements*	-13	-6	-6	-7	-12	-13	-14
Other**	30	14	32	64	36	39	26
Closing CFR	538	546	572	629	653	679	691
Total movement in CFR	**17**	**8**	**26**	**57**	**24**	**26**	**12**

*Other financing movements include the addition to fixed assets on Balance Sheet under PFI, e.g. £13.0m projection for street lighting in 2011/12
** Net financing need for the year, i.e. capital expenditure to be met by borrowing

17. Against the net financing (borrowing) need shown in table 1, the Council's Operational Boundary on its external debt position for this period and the maximum amount it could borrow is shown in table 3:

Table 3: Operational boundary 2010/11 - 2016/17

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
	Actual	Projected			Estimated		
	£m	£m	£m	£m	£m	£m	£m
Operational Boundary	567	567	602	655	686	698	689
Authorised Limit	624	624	662	719	753	768	760

18. The impact on Council Tax of the schemes starting in these years being approved as part of this budgetary cycle is shown in table 4.

Table 4: Estimated incremental impact of capital investment decisions on council tax 2012/13 to 2016/17

	2012/13	2013/14	2014/15	2015/16	2016/17
	£	£	£	£	£
Band D Council Tax	0.67	8.17	19.11	21.17	23.72

19. The expected position of the Council's year-end investment portfolio is shown below. The Prudential Indicator limiting longer-term deposits is also shown. However, the current Treasury Management strategy limits deposit terms to no longer than a year.

Table 5: Total investments at year-end and prudential indicator for investments over one year

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
	Actual	Projected			Estimated		
	£m	£m	£m	£m	£m	£m	£m
Total Investments	152	100	100	100	100	100	100
Principal sums invested more than 1 year	35%	35%	35%	35%	35%	35%	35%

Limits to borrowing activity

20. Within the Prudential Indicators, there are a number of key indicators to ensure that the Council operates its borrowing activities within well-defined limits.

21. The first key control over the Council's borrowing activity is to ensure that total net borrowing, does not, except in the short term, exceed the total CFR in the proceeding year plus the estimates of any additional CFR for the coming and the next two financial years. This allows some flexibility for limited early borrowing for future years. Table 6 shows that the projected net borrowing is below the CFR.

Table 6: Net borrowing 2011/12 to 2016/17

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
	Projected			Estimated		
	£m	£m	£m	£m	£m	£m
Gross Borrowing	320	330	370	381	394	394
Investments	-100	-100	-100	-100	-100	-100
Net Borrowing	**220**	**230**	**270**	**281**	**294**	**294**
CFR	546	572	629	653	679	691

22. The Chief Finance Officer reports that the Council has complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans and the proposals in this budget report.

23. A further two Prudential Indicators control or anticipate the overall level of borrowing. These are:

- The Authorised Limit;
- The Operational Boundary

The authorised limit for external debt

24. This represents the limit beyond which borrowing/external debt is prohibited, and this limit needs to be set or revised by Full Council. The limit reflects the level of borrowing which, while not desired, is affordable in the short term, but is not sustainable in the long-term. It is the expected maximum borrowing need with headroom for unexpected cash-flow eventualities. This is a statutory limit determined under section 3(1) of the Local Government Act 2003.

The operational boundary

25. This indicator is based on the expected maximum external debt during the course of the year; it is not a limit and actual borrowing could vary around this boundary for short periods during the year. It should act as an indicator to ensure the authorised limit is not breached.

26. The Council is asked to approve the following Authorised Limits and Operational Boundaries:

Table 7: External debt, authorised limit and operational boundary 2011/12 to 2016/17

	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
	Budget			Estimated		
	£m	£m	£m	£m	£m	£m
Authorised Limit for External Debt:						
Borrowing	567	593	637	661	680	677
Other long term liabilities	57	69	82	92	88	84
Total	**624**	**662**	**719**	**753**	**768**	**761**
Operational Boundary for External Debt:						
Borrowing	510	533	573	594	610	605
Other long term liabilities	57	69	82	92	88	84
Total	**567**	**602**	**655**	**686**	**698**	**689**

27. An optimum method of rescheduling debt may involve the council borrowing and repaying debt on separate days to utilise interest rate movements. To ensure the Council can take advantage of such an opportunity, if it were to arise, the Authorised Limit calculation incorporates some headroom for the restructuring of existing debt.

Affordability prudential indicators

28. The previous sections cover the overall capital expenditure and control of borrowing prudential indicators. Within this framework additional prudential indicators are required to assess the affordability of capital investment plans. These provide an indication of the impact of the capital investment plans on the overall Council's finances. The Full Council is asked to approve the following indicators:

Actual and estimates of the ratio of financing costs to net revenue stream

29. This indicator identifies the trend in the cost of capital (borrowing and other long-term obligation costs, net of interest and investment income) against the net revenue stream or budget requirement. The estimates of financing costs include current commitments and the impact of the proposals in this budget report are included within table 8.

Estimates of the incremental impact of capital investment decisions on Band D council tax

30. This indicator identifies the revenue costs associated with schemes introduced in the five year capital programme recommended in this budget report and compares the costs to the Council's existing approved commitments and current plans. The forward assumptions are based on the budget, but will invariably include some estimates, such as the level of government support, which are not currently known for future years.

31. Where capital expenditure plans will not realise a full year effect within five years, forward estimates are required until they do, therefore this indicator has also been estimated for 2016/17.

32. The financing cost of 'supported borrowing' has not been revenue grant funded since

2006/07. As a result of this, the table below shows the impact of borrowing under the Prudential Code.

Table 8: Ratio of financing costs to net revenue stream and impact on council tax

	2011/12 Projected	2012/13	2013/14	2014/15 Estimated	2015/16	2016/17
Ratio of Financing Costs to Net Revenue Stream	5.18%	5.10%	5.09%	5.80%	5.80%	5.72%
Incremental Impact on Council Tax*	n/a	0.67	8.17	19.11	21.17	23.72

***** Band D

<u>TREASURY MANAGEMENT STRATEGY AND PRUDENTIAL INDICATORS 2012/13 – 2016/17</u>

33. The treasury management function is an important part of the overall financial management of the Council's affairs. The Prudential Indicators covered above consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury function considers the effective funding of these decisions. Together they form part of the process, which ensures the Council meets a balanced budget requirement under the Local Government Finance Act 1992. There are specific treasury prudential indicators included in this strategy that require approval.

34. The Council's treasury management activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). This Council adopted the Code of Practice on Treasury Management in 2002 and as a result produced a treasury management policy statement. This adoption meets the requirements of the first of the treasury prudential indicators.

35. The policy statement requires an annual strategy to be reported to the Full Council, outlining the expected treasury activity for the forthcoming 5 years. This report also includes detail on investment and counterparty issues and associated recommendations. Prior to 2010/11, Audit & Governance Committee would agree the detail on investment and counterparty issues. Audit and Governance Committee therefore has a scrutiny role for treasury management and will receive two further reports during the year; the first a mid-year review as at 30 September and the second a report on actual activity for the year to 31 March. In addition, reports on treasury management activity are to be incorporated into quarterly budget monitoring reports to Cabinet.

36. Members' involvement in determining treasury management strategy is essential in order that the Council can demonstrate that capital expenditure plans are affordable, external borrowing is prudent and sustainable and that treasury decisions are taken in accordance with good practice.

37. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury management function.

    This strategy covers:

- The Council's debt and investment projections;
- The expected movement in interest rates;

- The Council's borrowing and investment strategies;
- Treasury performance indicators;
- Specific limits on treasury activities;
- Local treasury issues.

Debt & investment projections 2012/13 – 2016/17

38. The borrowing requirement comprises the expected movement in the CFR and any maturing debt that may need to be re-financed during each year. Table 9 shows this effect on the treasury position over the next five years. It also highlights the expected change in investment balances.

Table 9: Debt & investment projections 2010/11 - 2016/17

	2010/11 Actual £m	2011/12 Revised £m	2012/13 £m	2013/14 £m	2014/15 Estimated £m	2015/16 £m	2016/17 £m
Debt at 1st April	321	331	320	330	370	381	394
Movement in CFR	18	8	26	57	24	26	12
Less: Maturing Debt	-1	0	0	-68	0	0	0
Less: CFR increase due to PFI assets	-15	-17	-16	-17	-13	-13	-13
Maturing Debt Replacement	0	0	0	68	0	0	0
Change in Short-Term Borrowing*	0	0	0	0	0	0	0
Adjustment for Prior Years**	8	-2	0	0	0	0	0
Debt at 31st March	331	320	330	370	381	394	393
Operational boundary	567	567	602	655	686	698	689
Investments							
Investments at 31st March	-100	-100	-100	-100	-100	-100	-100
Investment Change	0	0	0	0	0	0	0

* Balances held on behalf of Surrey Police Authority

** Under borrowing in year

39. The related impact of the above movements on the revenue budget is shown in table 10.

Table 10: Interest payable and receivable 2010/11 – 2016/17

	2010/11 Actual £m	2011/12 Projected £m	2012/13 £m	2013/14 £m	2014/15 Estimated £m	2015/16 £m	2016/17 £m
Interest on Borrowing	13	15	15	17	20	22	24
Investment Income	-1	-1	-1	-1	-1	-1	-2
Net Interest Paid	12	14	14	16	19	21	22

40. In 2010/11 the Council reversed its longstanding strategy of borrowing to meet the CFR,

by repaying or rescheduling longer term PWLB debt in order to realise short-term savings. The interest on the borrowing figures above are those payable on existing borrowing to fund capital expenditure plans in the budget report. Within the actual revenue budget for interest payable there is an amount included to facilitate potential changes in the Council's borrowing strategy.

41. The Council is able to undertake temporary borrowing for cash-flow purposes, however none is expected to be required during 2012/13. The Council manages cash on behalf of Surrey Police Authority and a small number of trusts, which is classified as temporary borrowing. The Council is strictly prohibited from borrowing to invest, i.e. external borrowing must be clearly linked to the capital programme rather than as a means to generate income by borrowing to invest at a higher rate of interest than the borrowing rate.

42. Despite the likelihood of long-term interest rates increasing, further debt restructuring is unlikely to be an option due to the high premiums payable on the longer dated debt. Also, following the Comprehensive Spending Review, the PWLB increased borrowing interest rates by approximately 1%, without changing debt redemption interest rates. This will make PWLB debt rescheduling more problematic in the future. The Chief Finance Officer and the treasury advisers will monitor prevailing rates for any opportunities to reschedule during the year.

43. The Council also manages working balances for the Surrey Pension Fund. Communities and Local Government (CLG) issued new regulations for the Local Government Pension Scheme (The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009). These regulations included a stipulation that Administering Authorities operate pension funds from a separate bank account. The new bank account arrangements went live on 1 April 2011.

44. The key treasury impact of having the new account in place is that deposits placed on behalf of the Pension Fund are no longer co-mingled with other balances but placed on deposit in the name of the Fund. However, the Pension Fund's Investment Advisers Group (IAG) has agreed that the Pension Fund's counterparty strategy should mirror that of the council. In practice this means that the counterparties available to the Fund are restricted to those on the council's counterparty list. The IAG will review the Fund's treasury strategy on an annual basis following the approval of the council's treasury strategy.

Expected movement in interest rates

45. The Council has retained Sector as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Table 11 gives Sector's interest rate forecasts:

Table 11: Sector's interest rate forecasts (January 2012)
Medium-term rate estimates (averages)

Annual Average %	Bank Rate	Money Rates (lending)		PWLB Rates (borrowing)		
		3 month	1 year	5 year	20 year	50 year
March 2012	0.50	0.70	1.50	2.30	4.20	4.30
June 2012	0.50	0.70	1.50	2.30	4.20	4.30
Sept 2012	0.50	0.70	1.50	2.30	4.30	4.40
Dec 2012	0.50	0.70	1.60	2.40	4.30	4.40
March 2013	0.50	0.75	1.70	2.50	4.40	4.50
June 2013	0.50	0.80	1.80	2.60	4.50	4.60
Sept 2013	0.75	0.90	1.90	2.70	4.60	4.70
Dec 2013	1.00	1.20	2.20	2.80	4.70	4.80
March 2014	1.25	1.40	2.40	2.90	4.80	4.90
June 2014	1.50	1.60	2.60	3.10	4.90	5.00

45. 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 2 of 2012/13 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.

46. 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.

47. 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 (cost of carry).

Borrowing and debt strategy 2012/13 – 2016/17

54. The Council borrows money to finance the amount of our capital spending that exceeds receipts from: grants, third party contributions, capital receipts and reserves. The cost of borrowing to the Council as a whole comprises interest charges and Minimum Revenue Provision (MRP). For budgeting purposes it is assumed that for every £10 million of capital spend there are revenue costs of £1 million for 25 years. This is because it is assumed that new borrowing will be taken out at 5% while MRP is 5% and that a 25 year loan covers the average lifetime of capital assets.

55. The council is required to consider CIPFA's Prudential Code to set a ceiling on our borrowing based on our ability to finance the loans (including interest payable and Minimum Revenue Provision). We can borrow from internal and external sources. In the past two to three years we have been able to borrow internally due to the level of cash balances that the council holds. Cash is held due to a number of factors including: holding balances on behalf of third parties such as schools and Surrey Police Authority, receiving grant in advance of expenditure and unspent borrowing.

56. Internal borrowing is the financing of capital expenditure using internal resources, balances and reserves. This is cheaper than external borrowing, with no interest payments made. This leads to reduced cash levels and interest received on those balances. Prior to the credit crunch the council would borrow money to fund the capital programme – borrowing at long-term rates that were lower than the rates available for short-term investment. However, when investment rates fell it was financially attractive to repay debt – repayment and debt rescheduling activity in the 2009 calendar year resulted in savings in interest charges of £8 million per annum.

57. The option of postponing external borrowing (at high cost) and running down investment balances by borrowing internally has been implemented over the last three years. Reducing the level of cash balances held by the council has also eased pressure on the list of banks and other institutions (known as counterparties) that the council can place deposits with, thus enabling the return on investments to be maximised without added further counterparty risk.

58. Despite the likelihood of long-term interest rates increasing, further debt restructuring is unlikely to be an option due to the high premiums payable on the longer dated debt. Also, following the Comprehensive Spending Review, the PWLB increased borrowing interest rates by approximately 1%, without changing debt redemption interest rates. This will make PWLB debt rescheduling more problematic in the future. The Chief Finance Officer and the council's treasury advisers will monitor prevailing rates for any opportunities to reschedule during the year.

59. However, the scope for ongoing internal borrowing is limited given the amounts of debt that has been repaid (and is due to be repaid) and the consequent reduction in cash balances. The council will have to borrow externally at some point in the next five years if the capital programme is fully realised.

60. The Pension Fund and Treasury team monitor the council's cashflow and prevailing and projected interest rates to determine the most prudent (and affordable) time to borrow. Sector, the council's treasury management advisors, provide technical advice to enable officers to effectively manage the council's borrowing and investment portfolios. Sector's latest interest rate forecasts are summarised in table 11.

61. In consultation with an Audit and Governance Committee treasury management working group, officers have determined appropriate trigger points for borrowing. These trigger points relate to interest rates available on new borrowing and actual and projected cashflows. These triggers can be found in paragraph 72. Assuming that interest rates remain as projected it is planned that external borrowing will resume in 2013/2014 as cash balances run to minimum operational levels because an existing loan (of £68 million) is due to be repaid. To be prudent, the assumed rate of interest on new borrowing is 5%.

62. The council can borrow from a number of different external sources: the Public Works Loans Board (PWLB), banks and other local authorities. Historically the council has borrowed from the PWLB (with one small bank loan in the portfolio). The PWLB remains the most attractive option for longer-term borrowing given the low cost and ease of access to funds. Borrowing from other local authorities over the short-term is an attractive option for funding day-to-day cashflow needs, for example if expected cash inflows (such as government grant) are not received as advised.

Debt Risk

63. The key risks associated with the current strategy of funding capital expenditure through internal resources until it is necessary to borrow externally are as follows:

• Interest rate movements	The Pension Fund and Treasury team monitors interest rates on a daily basis and receives technical advice on the likelihood of borrowing rates rising
• Cap on PWLB borrowing	Alternative sources of funding can be sought, e.g. bank loans or bond issuance
• Cap on all borrowing	It is unlikely that government would penalise authorities that have prudently managed the borrowing portfolio over recent years, particularly given the impact of capital expenditure on the economy. The council has 'under-borrowed' compared to the total capital financing requirement (CFR) by around £200 million in recent years.
• Investment risk	Borrowing ahead of cashflow need means that there is a high cost of carrying debt at a time when investment income is low. To ease the revenue implications of borrowing it would be necessary to increase the risk on the investment portfolio (for example by relaxing the council's minimum credit rating criteria or by extending the maximum period over which cash can be invested) at a time when there is so much uncertainty about the economic and banking background. Sector's advice is that the council should continue to use the higher quality counterparties for shorter time periods.

64. The council's financial statements are required to disclose the impact of risks on the Council's treasury management activity. Whilst most of the risks facing the treasury management service are related to investment, and addressed elsewhere in this report (credit risk, liquidity risk, market risk, maturity profile risk), the impact of interest rate risk is discussed but not quantified. Table 12 highlights the estimated impact of a 1% increase/decrease in all interest rates to treasury management costs/income for next year. Elements of the debt and investment portfolios that are of a longer term, fixed interest rate nature will not be affected by interest rate changes.

Table 12: Interest rate sensitivity

	2012/13 Estimated £'000	2012/13 The estimated change if the interest rate is 1% more than forecast +1%	2012/13 The estimated change if the interest rate is 1% less than forecast -1%
Interest on Borrowing	15,163	-621	-847
Investment income	-1,046	-452	1,046
Net effect on the revenue budget	**14,117**	**-1,073**	**199**

Investment strategy 2012/13

65. The primary objectives of the Council's investment strategy are: firstly, safeguarding the repayment of the principal and interest of its investments on time and secondly ensuring adequate liquidity. The investment return is the third objective. Given the well-documented economic and banking background, the current investment climate has one over-riding risk consideration, being counterparty risk. As a result of these underlying concerns, officers are implementing an operational investment strategy that maintains the tight controls already in place from the previously approved investment strategy.

66. It is expected in 2012/13 that Surrey County Council will seek to maximise its return on investments by retaining call account deposits in part nationalised banks (Lloyds and RBS) which pay a premium due to their weakened Financial Strength. It is possible that this premium will be removed at some point during the coming year as the Government encourages banks to secure longer-term deposits. In addition, the council will utilise Money Market Funds (up to the value of £100m), and term deposits with HSBC and Barclays, should rates remain attractive. Any further cash will be offered to local authorities that seek to borrow cash from alternative sources to the PWLB.

67. As part of the recommendations contained within the Treasury Management Half Year Report 2010/11, The Audit & Governance Committee agreed to the reinstatement of any foreign bank which meets Surrey's counterparty criteria, on the condition that the Sovereign Rating for the country the institution is domiciled in is rated at "AAA" with Fitch, Standard and Poor's and Moody's. This change allows some flexibility with regard to depositing funds should any significant borrowing take place during the year. This also provides some protection against any further failure of banks in the UK by allowing country diversification. The Audit & Governance Committee will consider any further recommendations on amendments to the Council's credit rating criteria and deposit limits during the year, although it is unlikely that there will be any further significant changes to the criteria in Appendix 2.

68. The Chief Finance Officer, under delegated powers, will undertake the most appropriate form of investments depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above. All investments will be made in accordance with the Council's investment policies and prevailing legislation and

regulations. If the list of counterparties and their time or value limits need to be revised, amendments will be recommended to the Audit & Governance Committee.

Treasury management prudential indicators and limits on activity

69. There are four further treasury prudential indicators. The purpose of these prudential indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However, if these indicators are set to be too restrictive they will impair the opportunities to reduce costs. The indicators are:

- **Upper Limits on Variable Rate Exposure** – this indicator identifies a maximum limit for the level of debt (net of investments) taken out at variable rates of interest.
- **Upper Limits on Fixed Rate Exposure** – similar to the previous indicator this covers a maximum limit on the level of debt taken out at fixed rates of interest.
- **Maturity Structures of External Borrowing** – these gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.
- **Total Principal Funds Invested for Longer than 364 days**– these limits are set to reduce the need for the early sale of an investment, and are based on the availability of investments after each year-end.

70. Actuals and projections against these indicators for 2010/11 and 2011/12 are shown in table 13. The council is asked to approve the following prudential indicators:

Table 13: Treasury management prudential indicators

	2012/13 - 2016/17		2011/12 year-end projection	
Upper Limits on Fixed Interest Rates	150%			
Upper Limits on Variable Interest Rates	-50%			
Maturity Structure of External Borrowing	Lower	Upper	£m	
Under 12 months	0%	50%	16	5%
12 months to 2 years	0%	50%	68	21%
2 years to 5 years	0%	50%	0	0%
5 years to 10 years	0%	75%	10	3%
10 years and above	25%	100%	228	71%
Total External Borrowing			321	100%
Maximum Principal Sums Invested for more than 364 days*	35% of value of Investments		0	0%

*all investments are currently restricted to terms of less than 1 year

71. The upper limit percentages for fixed and variable interest rates result in extreme values of less than zero or more than 100%. This is due to the Prudential Indicator netting off the limits on borrowing and those on investments. The authority has adopted a treasury management strategy that favours fixed rate borrowing and investment to allow certainty over borrowing costs and rates of interest.

Borrowing Trigger Points – Cashflow

72. When setting a number of trigger point, it is important to understand the scope of the cash available, to give the trigger point context :

Current cash position:	£128m (as at 31/12/2011)
Cash high point:	£254m (July 2011)
Predicted average cash:	£175m (April – March 2012)
Total average investments:	£275m (April – March 2012)
Current borrowing position:	£305m (as at 31/12/2011)
Next debt repayment due:	£68m on the 30 September 2013

Given the scope of the figures above, we propose three basic cashflow triggers based upon (1) current short term, (2) average medium term, and (3) replacement of any debt to be repaid:

1. Available daily cash drops below £15m
2. Medium term cash drops below £50m
3. The repayment of any current borrowing

Borrowing Trigger Points – Interest Rates

73. When setting the interest rate trigger, reference should be made to the rate when setting the budget in the MTFP. The MTFP for 2012/17 sets rates based upon borrowing from the Public Works Loans Board on a maturity basis, at a rate of 5.0%, which is considered prudent given the projections for PWLB rates shown in table 11.

Using the figures in the MTFP, we can set suggested trigger points for discussion about whether it is appropriate to borrow, and for what term, based on PWLB rates as set out below:

PWLB 10 year maturity	5.0%
PWLB 25 year maturity	5.0%
PWLB 50 year maturity	5.0%

Performance Indicators

74. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy and effectiveness of the treasury management function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. Examples of performance indicators often used for the treasury function are:

- Debt – Borrowing - Average rate of borrowing for the year compared to average available

- Debt – Average rate movement year on year
- Investments – Internal returns above the 7 day LIBID rate

The results of these indicators will be reported to the Audit & Governance Committee in the Half Yearly Report, due after 30 September 2012, and the Treasury Management Annual Report for 2012/13. In addition, it is proposed that information on treasury management activity will be included in quarterly budget monitoring reports.

Risk Benchmarking

75. A development in the revised Code on Treasury Management and the CLG consultation paper, as part of the improvements to reporting, is the consideration and approval of security and liquidity benchmarks. This is to ensure that reporting of treasury activities are improved. Yield benchmarks are currently widely used to assess investment performance while discrete security and liquidity benchmarks are new reporting requirements.

Yield – the Council currently benchmarks the return on deposits against the 7-Day LIBID (London Interbank Bid Rate), and reports on this monthly as part of the budget monitoring report to Cabinet and as a performance indicator.

Security – the Council currently benchmarks historic risk of default when compared to the whole investment portfolio. This is reported at year-end.

Liquidity – the Council currently restricts the deposits with each counterparty to termed deposits only, the length of which is based upon individual assessment of each counterparty. The amount available for investment in any given day should never fall below £15m. This provides a safety margin, to help ensure the Council need not borrow to fund treasury activity, and a trigger point for possible short term borrowing.

Member and Officer Training

70. Officers and Members involved in the governance of the council's treasury management function are required to participate in training. Officers are also expected to keep up to date with matters of relevance to the operation of the council's treasury function. Officers continue to keep abreast of developments via the CIPFA Treasury Management Forum as well as through two local authority networks. Sector provides daily, weekly and quarterly newsletters and update meetings are held with Sector twice a year. In addition, a number of members of Audit & Governance Committee and council attended treasury management training in June 2011. Further member training will be provided on request.

Treasury Management Advisers

71. The Council uses Sector as its treasury management advisers. The company provides a range of services including:

- Technical support on treasury matters, capital finance issues and the drafting of Member reports;
- Economic and interest rate analysis;
- Debt services which includes advice on the timing of borrowing;
- Debt rescheduling advice surrounding the existing portfolio;

- Generic investment advice on interest rates, timing and investment instruments
- Credit ratings/market information service comprising the three main credit rating agencies

Local Issues – Deposits with Icelandic banks

72. The key local issue of concern in relation to the treasury strategy is the Council's £20m deposits with two failed Icelandic banks, Glitnir and Landsbanki. Of this £20m, the Council's exposure is £18.5m with the balance attributable to Surrey Police Authority. The details of the deposits are as follows:

Table 14: Deposits placed in Iceland

Counterparty	Date			Period	Principal £000	Rate
	Deal	Value	Maturity			
Glitnir	17/10/07	1/11/07	30/10/08	364	5,000	6.25%
Glitnir	11/10/07	31/10/07	31/10/08	366	5,000	6.20%
Landsbanki Islands	30/3/07	30/3/07	31/3/09	732	10,000	5.90%

73. To be prudent, the Council has earmarked balances of £9.5m on the assumption that a proportion of the deposits will not be recovered.

74. The current position is that of the hundreds of depositors that are party to the causes of action against the banks, a number of test cases were heard in Iceland in February and March 2011. The outcome of the test cases was that judges found that deposits placed by local authorities should be conferred with preferential creditor status. These decisions were then subject to an appeal by the unsuccessful parties (in general, bondholders). The council's claims against both banks were not test cases.

75. On 28 October 2011, the Supreme Court of Iceland upheld the District Court judgment in favour of local authority depositors, deciding by a 6-1 majority that local authorities' claims are deposits that qualify in full for priority in the bank administrations. Securing priority creditor status means that authorities with deposits in Glitnir should recover 100 per cent of their money, whilst those with deposits in Landsbanki are estimated to recover 98 per cent. The decision to confer priority creditor status on local authorities is now final and there is no further right of appeal.

76. In the case of the council's deposits in Glitnir the Supreme Court decision in the test case claims has now been applied to our claim and it has been accepted and approved as a priority claim. A court settlement in respect of our claim has been filed at, and approved by, the court.

77. In the case of Landsbanki, on 19th January 2012 the Icelandic District Court approved a court settlement in relation to our claim, recognising and approving our claim as a priority claim. Now that has happened, the winding-up board will arrange for the funds that are currently held in escrow in respect of our portion of the first distribution to priority creditors to be released to the council.

78. In the case of Glitnir, the winding-up board published its distribution proposal on 14 January 2012. That proposal takes Glitnir's asset base as at 30 September 2011 as the basis for calculating the currencies in which distributions will be made and in what proportion. The proposal envisages creditors being paid in a basket of five currencies

(GBP, EUR, USD, NOK and ISK) with other currencies being re-denominated into those currencies. When converting from ISK the amount of each of currency to be paid, the winding-up board will apply the foreign exchange (FX) rate for each currency on 22 April 2009 and not the FX rate on the date of the distribution. Our advisers are considering whether the proposal as published is lawful under Icelandic law and whether it prejudices the position of priority creditors. The proposal will then be discussed an upcoming open creditors meeting at which priority (or any other) creditors may object to the proposal. In the event that an objection is made, the dispute would need to be referred to the Icelandic Courts.

79. The position in Landsbanki is similar in principle, but there are two important differences. Cash held and available for distribution to priority creditors currently comprises only around one-third of the total assets: other assets held by the Winding Up Board are not readily convertible into cash and it will take a number of years for them to be realised. In addition, around 5% of the available cash is held in Icelandic Kronur, which cannot be converted into sterling or other international currencies without the permission of the Central Bank of Iceland.

80. We expect that the Council will receive a proportion of the distributions from both Landsbanki and Glitnir in Icelandic Kronur. Owing to currency restrictions, that element of the distribution must remain in Iceland until the restrictions are lifted or until the Central Bank of Iceland gives permission to exchange the Icelandic Kronur.

81. In practical terms, and allowing for the LGA's assumed recovery rates, we expect that the council will recover £18.3m of the £18.5m placed on deposit (Surrey Police's share would be £1.48m). In addition, we also expect to recover interest of £0.574m in relation to the Glitnir deposit (£47k for Surrey Police). The actual sterling amount received will be dependent on foreign exchange fluctuations. The timing of the payments is as yet unknown.

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Sources/background papers:

CIPFA Prudential Code for Capital Finance

CIPFA Treasury Management in the Public Services: Code of Practice

Investment guidelines under section 15(1)(a) of the Local Government Act 2003

Audit Commission: 'Risk & Return: English local authorities and the Icelandic banks'

Audit & Governance Committee papers 24 June 2004

EXTRACT FROM REPORT TO AUDIT AND GOVERNANCE COMMITTEE 24 JUNE 2004 (updated to reflect current treasury practice)

TITLE: INVESTMENTS UNDER SECTION 15(1)(a) OF THE LOCAL GOVERNMENT ACT 2003

INSTITUTIONS

2.1 Under the new investment regime the Council will use specific credit ratings to determine which institutions can be used for investments. For specified investments (defined in paragraph 3.2) an institution will require the highest short-term credit rating from at least one of the three main credit rating agencies. For non-specified investments (defined in paragraph 3.6), the criteria base will be increased to include the other main rating categories to ensure that any institutions used for lending in excess of 364 days are of the highest overall credit quality.

Banks and Building Societies

2.2 For banks and building societies the following *minimum* requirements as recommended by Sector, the Council's treasury and capital consultants, will permit only high quality institutions to be on the Council's lending list but will also allow a wide spread of institutions to choose from:

Rating	Current (Fitch only)	Proposed (Fitch or equivalent from Moody's and Standard & Poor)
Short-term	F1	F1
Long-term	A	A
Individual / Financial Strength	B/C	C
Support	3 (banks) 4 (building societies)	3 (banks) 3 (building societies)

2.3 Equivalent ratings are used as not all institutions are rated by all three rating agencies. Where an institution is rated by more than one agency, the lowest ratings will be used to determine whether it qualifies for inclusion on the list. This practice is known as the "Lowest Common Denominator" approach.

Money Market Funds

2.4 The County Council currently uses four money market funds on a regular basis. The new regulations and investment guidelines refer to the use of money market funds through the statement "…investment scheme which has been awarded a high credit rating…" This is interpreted as only including funds with a AAA rating from either Fitch, Moody's or Standard & Poor (i.e. the highest possible rating).

Other Institution Types

2.5 The following institutions are mentioned explicitly in the new guidance and associated legislation. Councils are not expected to lay down specific criteria for including these types of institution as they are either UK government institutions or have a UK government guarantee.

- UK Government including Gilts and the Debt Management Office
- Local authorities as defined by the Local Government Act 2003
- Supranational institutions, e.g. the European Investment Bank

2.6 A breakdown of the minimum credit rating criteria across all types of institution and funds is given in the resultant lending list in Appendix 2.

TYPES OF INVESTMENT

3.1 Under the new regime investments are split into two types: those that are specified and those that are non-specified.

Specified Investments

3.2 Specified investments are investments that:

- are denominated in Sterling;
- have a high credit rating (where applicable);
- are less than one year in length.

3.3 As the short-term rating of all three credit rating agencies is concerned with investments of up to 12 months in length, this should be the mainstay of the Council's lending criteria.

3.4 Specified investments include investments with:

- *UK Government*: This will include Debt Management Office, UK Treasury Bills or gilts with less than one year to maturity. No credit rating criteria is needed.
- *Supranational Bonds*: Multilateral development bank bonds or those issued by a financial institution that is guaranteed by the UK government. These are officially defined and therefore there is no need for any further credit rating criteria. The term to final maturity of these investments must be less than one year.
- *Local Authority as defined by the Local Authority Act 2003*: No credit rating criteria needed.
- *Money Market Funds (Investment Schemes)*: Investments made with Money Market Funds, which have been awarded a AAA rating with each of the three credit rating agencies.
- *Highly Credit Rated Body*: Investments made with a bank or building society from the Council's lending list with less than one year to maturity.

3.5 Historically the County Council has only undertaken investments that would now be classified as specified.

Non-Specified Investments

3.6 Non-specified investments are investments that:

- are in institutions that have no credit ratings or have ratings that do not qualify the institution for specified investment status;
- are in excess of one year;
- are investment instruments other than money market deposits.

3.7 Non-specified investments include investments in:

- *Supranational Bonds*: Multilateral development bank bonds or those issued by a financial institution that is guaranteed by the UK government. These are officially defined and therefore there is no need for any further credit rating criteria. The term to final maturity of these investments is one year or more.
- *Gilts*: These are officially itemised in the Guidance and therefore there is no need for a credit rating criteria.
-
- *Bank or Building Society Fixed Term Deposits*: Investments in banks or building societies for fixed periods of more than 364 days.
- *Non-Rated Subsidiary*: The County Council will not invest in subsidiaries that do not have ratings from one of the three main credit rating agencies.

Table 15: Effective Counterparty Limits 31 March 2011

	Fitch				Moody's			S&P		
Type	ST	LT	VIA*	Sup	ST	LT	FSR	ST	LT	Maximum Value
Bank / BS	F1	A-	BB+	3	P-1	A3	C	A1	A-	£20m
Bank / BS	F1+	AA-	A-	2	P-1	Aa3	B	A1+	AA-	£25m
Bank / BS	F1+	AA	A-	1	P-1	Aa2	B	A1+	AA	£35m
MMF	AAA				AAA			AAA		£20m
DMADF	-				-			-		Unlimited
Supranational	-				-			-		£10m
Local Authority	-				-			-		£20m

* Fitch Viability rating replaced the Individual Strength rating in December 2011

i) Deposits are permitted with UK banks that do not comply with the council's credit rating criteria subject to the following:

a) That they have been nationalised or part nationalised by the UK government and/or

b) That they have signed up to the UK government financial support package

ii) The use of Money Market Funds is restricted to Funds with three AAA ratings up to a maximum of £100m (with a maximum of £20m per Money Market Fund)

iii) An additional £20m is made available to invest in overnight high interest call accounts with both RBS and Lloyds (making a total of £40m limit with each). This will be maintained while they remain part nationalised.

iv) Deposits with foreign banks are permitted, on the condition that they meet our minimum criteria, and that the country in which the bank is domiciled is "AAA" rated with all three ratings agencies (Fitch, Moody's and Standard and Poor's).

GLOSSARY

MMF = Money Market Fund; DMADF = Debt Management Account Deposit Facility at the Bank of England; BS = Building Society. ST = Short-Term; LT = Long-Term; Ind = Individual rating; Sup = Support rating; FSR = Financial Strength Rating.

F1 Indicates the strongest capacity for timely payment of financial commitments; an added "+" denotes any exceptionally strong credit feature.

P-1 Indicates superior credit quality and a very strong capacity for timely payment of short-term deposit obligations. No enhanced rating available.

A-1 Indicates a strong capacity to meet financial commitments; an added "+" denotes a capacity to meet financial commitments as extremely strong.

Table 16: Counterparty List as at 16 January 2012

	Fitch Ratings				Moody's Ratings			S&P Ratings	
	S/T	L/T	Via*	Supp	S/T	L/T	Str.	S/T	L/T
UK		AAA				AAA			AAA
Barclays	F1	A	A	1	P1	AA3	C	A1	A+
HSBC	F1+	A	AA-	1	P1	AA3	C	A1	A+
Lloyds	F1	A	BBB	1	P1	A1	C-	A-1	A
Royal Bank of Scotland	F1	A	BBB	1	P1	A2	C-	A1	A
Australia		AAA				AAA			AAA
National Australia Bank	F1+	AA	AA	1	P1	AA2	B-	A1+	AA-
Commonwealth Bank of Australia	F1+	AA	AA	1	P1	AA2	B-	A1+	AA-
Canada		AAA				AAA			AAA
Bank of Montreal	F1+	AA-	AA-	1	P1	AA2	B-	A1	A+
Bank of Nova Scotia	F1+	AA-	AA-	1	P1	AA1	B	A1+	AA-
National Bank of Canada	F1	A+	A+	1	P1	AA2	B-	A1	A
Royal Bank of Canada	F1+	AA	AAA	1	P1	AA1	B	A1+	AA-
Toronto-Dominion Bank	F1+	AA-	AA-	1	P1	AAA	B+	A1+	AA-
Denmark		AAA				AAA			AAA
Danske Bank	F1	A	A	1	P1	A2	C	A1	A
Finland		AAA				AAA			AAA
Nordea Bank	F1+	AA-		1	P1	AA2	C+	A1+	AA-
Germany		AAA				AAA		A1+	AAA
Deutsche Bank AG	F1+	A+	A	1	P1	AA3	C+	A1	A+
Netherlands		AAA				AAA			AAA
ING Bank	F1+	A+	A	1	P1	AA3	C+	A1	A+
Rabobank	F1+	AA	AA	1	P1	AAA	B+	A1+	AA
Singapore		AAA				AAA			AAA
Development Bank of Singapore	F1+	AA-	AA-	1	P1	AA1	B	A1+	AA-
Oversea Chinese Banking Corp	F1+	AA-	AA-	1	P1	AA1	B	-	-
United Overseas Bank	F1+	AA-	AA-	1	P1	AA1	B	A1+	AA-
Sweden		AAA				AAA			AAA
Svenska Handelsbanken	F1+	AA-	AA-	1	P1	AA2	C+	A1+	AA-
Switzerland		AAA				AAA			AAA
Credit Suisse Group	F1	A	-	-	P1	AA3	-	A1	A+
UBS AG	F1	A	A-	1	P1	AA3	C	A1	A

* Fitch Viability rating replaced the Individual Strength rating in December 2011