NOTTINGHAMSHIRE
Fire & Rescue Service
*Creating Safer Communities*

Nottinghamshire and City of Nottingham
Fire and Rescue Authority

# TREASURY MANAGEMENT STRATEGY 2010/11

Report of the Treasurer to the Fire Authority

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**Agenda Item No:**

**Date:** 28 May 2010

**Purpose of Report:**

To inform Members of the Authority's Treasury Management Strategy for 2010/11.
To seek adoption by Members of the Treasury Management Policy Statement.
To seek adoption by Members of the CIPFA Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes 2009.

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## 1. BACKGROUND

1.1 The Local Government Act 2003 requires the Authority to set out its treasury strategy for borrowing and to prepare an annual investment strategy; this sets out the Authority's policies for borrowing, for managing its investments and for giving priority to the security and liquidity of those investments.

1.2 The Authority has adopted the CIPFA Treasury Management in the Public Services Code of Practice (the Code) and related guidance. This Code was revised in the year, following the collapse of Icelandic banks and contains some new requirements which are set out in the body of this report. It is a requirement of the Code that the Authority creates and maintains:

- A treasury management policy statement, which states the policies, objectives and approach to risk management of its treasury management activities.
- Suitable treasury management practices, setting out how the Authority will seek to achieve those policies and objectives and how activities will be controlled and managed.

1.3 The treasury management policy statement is given in Appendix A. The Code also sets out four clauses relating to treasury management which should be adopted as part of financial regulations.

1.4 A report on the Prudential Code for Capital Accounting was approved by Members at the Authority's meeting on 19 February 2010. That report set out the prudential indicators for 2010/11, which are designed to ensure that the Authority's capital investment plans are affordable, prudent and sustainable and are in accordance with CIPFA's revised Prudential Code. This Treasury Management Strategy report is complementary to that Prudential Code report and the prudential and treasury limits approved by the Fire Authority on 19 February 2010 are repeated in Appendix B for completeness.

1.5 A Minimum Revenue provision policy for 2010/11 was approved by the Fire Authority on 19 February 2010.

1.6 The Authority has appointed Sector Treasury Services as its external treasury management adviser. Sector has provided the Authority with its view on anticipated interest rates for the forthcoming year.

1.7 This report was considered in detail by the Finance and Resources Committee at its meeting on 9$^{th}$ April and Members asked that it be submitted to the full Fire Authority for approval. It should be noted however that a further report is to be presented to the Finance and Resources Committee to explain in the detail the workings of AA Money Market Funds before these are actually used as an investment vehicle.

## 2. REPORT

**THE REVISED CIPFA TREASURY MANAGEMENT CODE OF PRACTICE 2009**

2.1 This report recommends that Members adopt the CIPFA Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes 2009.

2.2 It is a requirement of the revised Code that the Authority creates and maintains:

- A treasury management policy statement, which states the policies, objectives and approach to risk management of its treasury management activities.
- Suitable treasury management practices, setting out how the Authority will seek to achieve those policies and objectives and how activities will be controlled and managed.

The treasury management policy statement is attached at Appendix A and Members are asked to adopt this statement. A full set of updated treasury management practices was approved by Members of the Finance and Resources Committee on 27 March 2009 and will be reviewed again during 2010/11.

2.3 The revised Code sets out requirements for reporting on treasury management. The aim of these reporting arrangements is to ensure that those with ultimate responsibility for the treasury management function appreciate fully the implications of treasury management policies and activities, and that those implementing policies and executing transactions have properly fulfilled their responsibilities with regard to delegation and reporting.

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

| Area of Responsibility | Committee | Frequency |
|---|---|---|
| Treasury Management Policy Statement (revised) | CFA | Initial adoption in 2010 |
| Treasury Management Strategy / MRP policy | CFA | Annually before the start of the year |
| Treasury Management Strategy / mid year report | CFA | Mid year |
| Treasury Management Strategy / MRP policy – updates or revisions at other times | CFA | |
| Annual Treasury Management Outturn Report | CFA | Annually by 30 September after the end of the year |
| Treasury Management / Prudential Code Monitoring Reports – performance monitoring | Finance & Resources Committee – provide scrutiny | Quarterly |
| Treasury Management Practices | Finance & Resources Committee – provide scrutiny | Review every two years |

**TREASURY MANAGEMENT STRATEGY FOR 2010/11**

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

2.6 The Act therefore requires the Authority to set out its treasury strategy for borrowing and to prepare an annual investment strategy: this sets out the Authority's policies for managing its investments and for giving priority to the security and liquidity of those investments.

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

2.8 The strategy covers:

- Prudential and Treasury Indicators
- the borrowing requirement
- prospects for interest rates
- the borrowing strategy
- policy on borrowing in advance of need
- debt rescheduling
- the investment strategy
- creditworthiness policy
- policy on use of external service providers

2.9 The Authority recognises that whilst there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources, responsibility for treasury management decisions remains with the organisation at all times. The Authority will therefore ensure that undue reliance is not placed upon external service providers.

**BALANCED BUDGET REQUIREMENT**

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

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

**ECONOMIC BACKGROUND**

2.11 Previous reports to Members have described the credit crunch and its impact on both the UK and world economies. Economic growth has now started but predictions vary on how quickly the major world economies will recover from the recession and how strong that recovery will be. The following issues will all impact on growth and they are difficult to forecast:

- the general election and potential policy changes affecting interest rates and gilt yields
- timing and amounts of the reversal of quantitative easing
- potential changes in financial regulation affecting financial institutions
- speed of recovery of banks' profitability and balance sheet imbalances
- changes in the consumer savings ratio

- rebalancing of the UK economy towards exporting
- the risk of a “double-dip” recession, with falling demand, falling inflation and wages and rising unemployment

2.12 Sector Treasury Services has provided a forecast on the bank interest rate, which draws on current City forecasts:

| Sector Bank Rate Forecasts | |
|---|---|
| As at 31 March 2010 | 0.50% |
| As at 31 March 2011 | 1.00% |
| As at 31 March 2012 | 3.00% |
| As at 31 March 2013 | 4.50% |

**MANAGEMENT OF CASH RESOURCES**

2.13 The Authority uses a main current account, an investment account and a number of local petty cash accounts. All of these accounts are held with Barclays Bank PLC and are managed online. This system allows the Authority to make transfers to and from accounts in real time and thus allows the current account balance to be maintained at a minimum level. All surplus funds are held either in the investment account for short periods or are lent to institutional borrowers over longer periods.

2.14 The bank overdraft level is £200,000 and this is usually sufficient. There are occasions when the overdraft exceeds £200,000 and temporary arrangements are made with the bank to increase the limit to £500,000. The Prudential Code report included an overdraft limit of £500,000 within the authorised limit to allow for such instances. It is proposed that the overdraft facility remains at a level of £200,000.

2.15 A 3 year cash flow projection is prepared together with a 3 month rolling cash flow forecast. The 3 month forecast is updated regularly and this process reveals when cash surpluses will arise.

2.16 The current bank account is cleared to zero on a daily basis with the balance being transferred to the investment account (Business Premium Account).

2.17 Cash management processes have been examined by internal auditors and have been shown to be robust.

**BORROWING STRATEGY**

2.18 The prudential indicators for borrowing are set out in Appendix B. Background information relating to these indicators was contained within the Prudential Code for Capital Accounting report approved by Members of the Fire Authority on 19 February 2010.

2.19 The capital financing requirement is the sum of money required from external sources to fund capital expenditure i.e. the Authority's underlying need to borrow or lease. This is not necessarily the amount that will actually be borrowed or leased in any given year as those decisions are made as part of the wider management of cash.

2.20 The Authority's strategy in the past has been to borrow funds from the Public Works Loan Board (PWLB). The PWLB is an agent of HM Treasury and its function is to lend money from the National Loans Fund to local authorities and other prescribed bodies. Its interest rates are generally favourable compared to those applicable to borrowings from other sources within the marketplace. However, in 2007/08, a £4m loan was borrowed from a bank, with a fixed interest rate which was lower than the equivalent PWLB rate. It is therefore proposed that the Authority continues to borrow primarily from the PWLB, but considers fixed rate market borrowing when market rates are lower than PWLB rates.

2.21 Sector's view on PWLB interest rates for 2010/11 is:

| | Mar 10 | Jun 10 | Sep 10 | Dec 10 | Mar 11 | Mar 12 | Mar 13 |
|---|---|---|---|---|---|---|---|
| Bank Rate | 0.50% | 0.50% | 0.50% | 0.50% | 1.00% | 3.00% | 4.50% |
| 5 yr PWLB | 3.05% | 3.10% | 3.15% | 3.20% | 3.40% | 4.50% | 4.85% |
| 10 yr PWLB | 4.35% | 4.35% | 4.45% | 4.50% | 4.60% | 4.95% | 5.15% |
| 25 yr PWLB | 4.75% | 4.75% | 4.80% | 4.85% | 4.90% | 5.20% | 5.35% |
| 50 yr PWLB | 4.75% | 4.75% | 4.80% | 4.85% | 4.90% | 5.15% | 5.30% |

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

- Rates are expected to gradually increase during the year so it should therefore be advantageous to time new long term borrowing for the start of the year when 25 year PWLB rates fall back to or below the central forecast rate of about 4.75%, a suitable trigger point for considering new fixed rate long term borrowing.
- Variable rate borrowing is expected to be cheaper than long term borrowing and will therefore be attractive throughout the financial year compared to taking long term fixed rate borrowing. The Authority's prudential limit for exposure to variable rate borrowing is 30%.
- PWLB rates on loans of less than ten years duration are expected to be lower than longer term PWLB rates. However, the existing debt maturity profile of the Authority may mean that longer term borrowing at a higher cost is required to give a balanced loans portfolio.
- There is expected to be little difference between 25 year and 50 year rates so therefore loans in the 25-30 year periods could be seen as being more attractive than 50 year borrowing as the spread between the PWLB new borrowing and early repayment rates is considerably less. This would maximise the potential for debt rescheduling and allow the Authority to rebalance its debt maturity profile.

- Consideration will also be given to borrowing fixed rate market loans at 0.25% – 0.50% below the PWLB target rate and to maintaining an appropriate balance between PWLB and market debt in the debt portfolio.

2.23 In normal circumstances the main sensitivities of the forecast are likely to be the two scenarios noted below. Officers, in conjunction with the treasury advisers, will continually monitor both the prevailing interest rates and the market forecasts, adopting the following responses to a change in position:

- if it were felt that there was a significant risk of a sharp **fall** in long and short term rates, e.g. due to a marked increase of risks around relapse into recession or of risks of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.
- if it were felt that there was a significant risk of a much sharper **rise** in long and short term rates than that currently forecast, perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

2.24 The amount of the Authority's cash balances and investments is currently low and the net debt position is therefore largely similar to the gross debt position. Over the next three years, investment rates are therefore expected to be below long term borrowing rates and this would indicate that value could best be obtained by avoiding new external borrowing and by using internal cash balances to finance new capital expenditure or to replace maturing external debt (this is referred to as internal borrowing). However, the Authority has already adopted this strategy to some extent over the last two years, and internal cash balances have been depleted to ensure security of funds.

2.25 On 18 December 2009, Members of the Fire Authority approved the proposal, outlined in a paper entitled "Revision to Treasury Management Strategy 2009/10, to reinstate the Authority's investments. Liquid investments should be in place to "cash-back" the Authority's reserves in case there is a requirement to call upon these reserves. This reinstatement will take place in stages over the next three years by way of borrowing and will result in a widening gap between the Authority's gross and net debt positions. It should be pointed out that this is not borrowing for the purpose of investment per se, but borrowing to reinstate liquid investments supporting the Authority's reserves, which have previously been realised and used to finance capital expenditure during the economic crisis. The investment strategy is outlined later in this report.

2.26 The Authority can expect to borrow in the region of £6m in 2010/11 to finance the capital programme and up to £2m to reinstate cash to support reserves. The figure of £6m may vary depending upon the results of options appraisals to determine whether assets are financed by leasing or borrowing. A final decision will be taken on loan terms at the time of borrowing, which will take account of interest rates at that time and the maturity profile of the existing debt portfolio. Caution will be adopted with the 2010/11 treasury operations - Officers will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to Members at the next available opportunity.

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

- ensure that borrowing is only undertaken to finance the capital programme approved within the current Medium Term Financial Strategy
- ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow
- consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use.

2.28 The rescheduling of debt involves the early repayment of existing borrowings and its replacement with new loans. The opportunity to reschedule debt may arise during the year and the reasons for pursuing this course of action include:

- the generation of cash savings and / or discounted cash flow savings,
- enhancing the balance of the portfolio by amending the maturity profile

2.29 Any rescheduling of debt will be reported to Members at the earliest meeting following its action.

**INVESTMENT STRATEGY**

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

(a) the security of capital and
(b) the liquidity of its investments.

The Authority will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Authority is low in order to give priority to security of its investments. The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Authority will not engage in such activity.

2.31 Investment opportunities will arise either when there are temporary cash surpluses or when funds are borrowed for the purpose of reinstating reserves (as outlined in paragraph 2.25). To determine the institutions with which investments may be placed, the Authority uses the creditworthiness service provided by Sector Treasury Services. This service has been progressively enhanced over the last year and now uses a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moodys and Standard and Poors forming the core element. However, it does not rely solely on the current credit ratings of counterparties but also uses the following as overlays: -

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

2.32 This modelling approach combines credit ratings, credit watches, credit outlooks and CDS spreads in a weighted scoring system for which the end product is a series of colour code bands which indicate the relative creditworthiness of counterparties. In previous years, the investment strategy has specified a minimum credit rating, however because a combination of information from different sources is now used this is not possible. Instead, Sector's colour codes are used by the Authority to determine both the credit-worthiness of institutions and the duration for investments. The Authority is satisfied that this service now gives a much improved level of security for its investments.

2.33 The selection of counterparties with a high level of creditworthiness will be achieved by selection of institutions down to a minimum durational band within Sector's weekly credit list of potential counterparties. The Authority will therefore use counterparties within the following durational bands:

- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 3 months

Institutions within the "purple band" (24 months) or with no colour band will not be used.

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

2.35 The Authority has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA from Fitch Ratings (or equivalent from other agencies if Fitch does not provide). The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix C. This list will be added to or deducted from by Officers should ratings change in accordance with this policy.

2.36 Previously, a list of institutions meeting the minimum lending criteria has been appended to the Treasury Management Strategy report to Members. Sector has advised that, with the current levels of uncertainty in the financial markets, the publication of such lists by local authorities might have a material impact on an institution which has been excluded from lists. Members of the Finance and Resources Committee were given an opportunity to inspect the latest list at the last meeting.

2.37 In accordance with its low risk appetite, the Authority may undertake the following types of “specified” investments:

- Deposits with the Debt Management Agency (Government)
- Term deposits with Banks and Building Societies
- Term Deposits with uncapped English and Welsh local authority bodies
- Triple-A rated Money Market Funds
- UK Treasury Bills

2.38 The risks associated with investing will be reduced if investments are spread e.g. over counterparties or over countries. The Authority will therefore limit its investment with any single counterparty to £2m. It is, however, difficult to impose any further spreading requirement due to the relatively small size of the Authority’s investments and the fact that investment institutions will often only accept a minimum investment sum, which may render any such policy unworkable. Despite this Officers will, wherever possible, avoid the concentration of investments with one counterparty or group.

2.39 The majority of past investments have been for periods of 3 months or less. In the current financial climate, no term deposit investments will be made for more than 1 year without the prior approval of the Treasurer and the Chair of Finance and Resources Committee. The Authority will avoid locking into longer term deals while investment rates are down at historically low levels unless exceptionally attractive rates are available which make longer term deals worthwhile.

2.40 All credit ratings will be monitored at least weekly, and the credit rating of any proposed counterparty will be checked on the day immediately prior to investing. The Authority is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service. If a downgrade results in the counterparty/investment scheme no longer meeting the Authority’s minimum criteria, its further use as a new investment will be withdrawn immediately. In addition to the use of Credit Ratings the Authority will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Authority's lending list.

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

## 3. FINANCIAL IMPLICATIONS

The financial implications of this report are set out in full within the body of the report.

## 4. HUMAN RESOURCES AND LEARNING AND DEVELOPMENT IMPLICATIONS

There are no human resources or learning and development implications arising directly from this report.

## 5. EQUALITY IMPACT ASSESSMENT

There are no equalities issues arising directly from this report.

## 6. CRIME AND DISORDER IMPLICATIONS

There are no crime and disorder implications arising directly from this report.

## 7. LEGAL IMPLICATIONS

There are no legal implications arising directly from this report, other than the requirement to act within the Authority's powers when undertaking treasury management borrowings and investments.

## 8. RISK MANAGEMENT IMPLICATIONS

The investment of local authority funds cannot be achieved without some element of risk. Careful choice of borrowers using creditworthiness indices will minimise this risk. This prudent approach will undoubtedly result in some interest rate loss but the principles of security and liquidity are paramount.

## 9. RECOMMENDATIONS

It is recommended that:

9.1 The Authority adopts the CIPFA Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes 2009.

9.2 Members adopt the Treasury Management Policy Statement as set out in Appendix A.

9.3 Members approve the Treasury Management Strategy for 2010/11 as set out in this report.

## 10. BACKGROUND PAPERS FOR INSPECTION (OTHER THAN PUBLISHED DOCUMENTS)

None.

PETER HURFORD
**TREASURER TO THE FIRE AUTHORITY**

Appendix A

## TREASURY MANAGEMENT POLICY STATEMENT

1. The Authority defines its treasury management activities as: “The management of the 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”.

2. The Authority regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.

3. The Authority acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.”

**Appendix B**

**PRUDENTIAL AND TREASURY INDICATORS APPROVED BY FIRE AUTHORITY FEBRUARY 2010**

| | |
|---|---|
| Estimate of Ratio of Financing Costs to Net Revenue Stream | 5.9% |
| Estimate of the Incremental Impact of the New Capital Investment Decisions on the Council Tax (Band D) | £2.67 |
| Estimate of Total Capital Expenditure to be Incurred | £6,689,000 |
| Estimate of Capital Financing Requirement | £33,326,000 |
| Operational Boundary | £32,746,000 |
| Authorised Limit | £36,021,000 |
| Upper limit for fixed rate interest exposures | 100% |
| Upper limit for variable rate interest exposures | 30% |
| Loan Maturity: | Limits: |
| Under 12 months | Upper 20% Lower 0% |
| 12 months to 5 years | Upper 30% Lower 0% |
| 5 years to 10 years | Upper 75% Lower 0% |
| Over 10 years | Upper 100% Lower 20% |
| Over 20 years | Upper 100% Lower 20% |
| Upper Limit for Principal Sums Invested for Periods Longer than 364 Days | £2,000,000 |

**Appendix C**

## APPROVED COUNTRIES FOR INVESTMENTS

| AAA | AA+ | AA |
|---|---|---|
| Canada | Australia | Hong Kong |
| Denmark | Belgium | Japan |
| Finland | | Kuwait |
| France | | UAE |
| Germany | | |
| Luxembourg | | |
| Netherlands | | |
| Norway | | |
| Singapore | | |
| Spain | | |
| Sweden | | |
| Switzerland | | |
| U.K. | | |
| U.S.A. | | |