NOTTINGHAMSHIRE
Fire & Rescue Service
Creating Safer Communities

Nottinghamshire and City of Nottingham
Fire and Rescue Authority

TREASURY MANAGEMENT STRATEGY 2011/12

Report of the Treasurer to the Fire Authority

Agenda Item No:

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Purpose of Report:

To inform Members of the Authority's Treasury Management Strategy for 2011/12.
To seek approval of the Authority's Minimum Revenue Provision Policy for 2011/12.

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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 Treasury management is defined as "the management of investments and cash flows, 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."

1.3 The Authority adopted the CIPFA Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes 2009 (the Code) on 9 April 2010. 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. This statement is given in Appendix A.
- 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.

1.4 A report on the Prudential Code for Capital Accounting was approved by Members at the Authority's meeting on 25 February 2011. That report set out the prudential indicators for 2011/12, which are designed to ensure that the Authority's capital investment plans are affordable, prudent and sustainable and are in accordance with CIPFA's 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 25 February 2011 are repeated in Appendix B for completeness.

1.5 This report also sets out the Authority's Minimum Revenue Provision Policy for 2011/12 for approval by Members in Paragraph 2.44.

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 has already been seen by the Finance and Resources Committee at its meeting on 11 April and has been passed to the Fire Authority for final approval.

2. REPORT

TREASURY MANAGEMENT STRATEGY FOR 2011/12

2.1 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.

2.2 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.

2.3 The suggested strategy for 2011/12 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.

2.4 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;
- The Minimum Revenue Provision policy.

2.5 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

2.6 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

2.7 The global economy last year saw two sovereign debt crises, with the European Union and International Monetary Fund providing financial support packages to both Greece and Ireland. Although there was some unexpectedly strong growth in the Eurozone in Quarter 2 of 2010, this was not sustained, and expectations are that growth in 2011 will be slow but not negative.

2.8 Following the general election in May 2010, the coalition government put in place an austerity plan to achieve correction of the public sector deficit over the next five years. There will be significant job losses over this period, particularly in the public sector, and potentially a lowering of consumer and business confidence. In February of this year, the Bank of England estimated UK growth for 2011 to be around 2%.

2.9 The Consumer Price Index hit 4% in January 2011 and may reach as much as 5% this year before starting to fall. The Bank of England's Monetary Policy Committee's target for inflation is 2% and future policy will aim to bring inflation back to the target level over the next two years.

2.10 Prior to the general election, credit rating agencies had been issuing warnings that unless there was a major fiscal contraction, the UK's AAA sovereign rating was at risk of being downgraded. However, after the Chancellor's budget in June 2010, confidence in the AAA rating returned.

2.11 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 2011	0.50%
As at 31 March 2012	1.00%
As at 31 March 2013	2.25%
As at 31 March 2014	3.25%

MANAGEMENT OF CASH RESOURCES

2.12 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.

2.13 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.

2.14 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.

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

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

BORROWING STRATEGY

2.17 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 25 February 2011.

2.18 The capital financing requirement is the sum of money required from external sources to fund capital expenditure, ie: the Authority's underlying need to borrow or lease. For 2011/12 this figure is estimated at £28,078,000, which is lower than would have been the case if the Authority had not approved the use of revenue reserves to finance future capital expenditure as part of the budget 2011/12 to 2014/15.

2.19 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.

2.20 Sector's view on future PWLB interest rates is:

	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Mar 13	Mar 14
Bank Rate	0.50%	0.50%	0.75%	1.00%	1.00%	2.25%	3.25%
5 yr PWLB	3.70%	3.70%	3.70%	3.80%	3.90%	4.30%	4.80%
10 yr PWLB	4.90%	4.90%	4.90%	4.90%	4.90%	5.20%	5.50%
25 yr PWLB	5.40%	5.40%	5.40%	5.40%	5.40%	5.50%	5.70%
50 yr PWLB	5.40%	5.40%	5.40%	5.40%	5.40%	5.50%	5.70%

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

- A combination of revenue reserves, capital grant and capital receipts will be used to finance the majority of capital expenditure in 2011/12 and 2012/13.
- Three PWLB loans mature in the short term (September 2012, September 2013 and September 2014) and these will need to be replaced with new loans.
- Sector's view is that PWLB rates will remain fairly constant throughout 2011/12, but are likely to rise in 2012/13 and again in 2013/14. It may therefore be advantageous to take out new loans next year before rates increase, as this will have a lesser impact on the revenue budget for the periods of the loans. Up to £2m could be borrowed in 2011/12, within the Authority's operational boundary for debt.
- Variable rate borrowing (up to 10 years) is expected to be cheaper than longer term fixed rate borrowing. However, with the bank rate expected to rise, variable rate borrowing will expose the Authority to the risk of increased interest costs so is unlikely to be taken. 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.
- 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.

2.22 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, eg: 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.

2.23 The Authority's gross debt position is £28m, but investments of approximately £7m are expected to be in place at 31 March 2011, giving a net debt position of around £22m. Some of these investments will be used over the next two years to finance capital expenditure from revenue reserves, which will narrow the gap between gross and net debt. Currently, investment interest rates are substantially lower than debt interest rates so using reserves rather than borrowing to finance capital expenditure will give better value for money in the short term. It must be pointed out though, that with interest rates likely to rise over the medium term, additional longer term costs will be incurred when surplus reserves have been exhausted and there is once more a requirement to borrow at higher rates.

2.24 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.

2.25 The rescheduling of debt involves the early repayment of existing borrowings and their replacement with new loans. The widened difference between PWLB new borrowing rates and PWLB premature repayment rates means that rescheduling would incur a substantial premium, which could not be justified on value for money grounds. If this differential reduces, rescheduling will be considered for the following reasons:

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

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

INVESTMENT STRATEGY

2.26 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.

2.27 Investment opportunities will arise when there are temporary cash surpluses. To determine the institutions with which investments may be placed, the Authority uses the creditworthiness service provided by Sector Treasury Services. This service 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.

2.28 This modelling approach combines credit ratings, credit watches, credit outlooks and CDS spreads in a weighted scoring system for which the end product is a series of colour code bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Authority to determine both the credit-worthiness of institutions and the duration for investments. It is regarded as an essential tool, which the Authority would not be able to replicate using in house resources.

2.29 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), the “yellow band” (5 years) or with no colour band will not be used.

2.30 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 tends to be 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.

2.31 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.

2.32 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. Instead, the latest credit list provided by Sector will be made available to Members at the meeting.

2.33 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.

2.34 The risks associated with investing will be reduced if investments are spread eg: over counterparties or over countries. The Authority will therefore aim to 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.

2.35 The majority of past investments have been for periods of three 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.

2.36 All credit ratings will be monitored via a weekly update from Sector. The Authority is alerted to changes to ratings of all three agencies as and when they occur 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.

2.37 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.

MINIMUM REVENUE PROVISION POLICY 2011/12

2.38 The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 came into force on 31 March 2008. These regulations were an amendment to the 2003 regulations and introduced several changes to the capital finance regime for local authorities (including fire authorities) in England. The most significant of these were new provisions dealing with the calculation of Minimum Revenue Provision (MRP), which is the amount an authority charges to its revenue account in respect of the financing of capital expenditure.

2.39 Under the regulations, Authorities must make a "prudent provision" for MRP and guidance is given on the interpretation of this: *"provision for the borrowing which financed the acquisition of an asset should be made over a period bearing some relation to that over which the asset continues to provide a service".* This guidance translates into the asset life method. Authorities are permitted to continue charging MRP calculated using the old method for borrowing and credit arrangements which funded capital expenditure incurred before 1 April 2007. This method calculates a charge of 4% of the capital financing requirement each year to revenue.

2.40 The following policy on MRP is therefore recommended to members and budgetary provision for MRP has been made on this basis:

- For all borrowing and credit arrangements to fund capital expenditure incurred before or during 2006/07, the minimum revenue provision applied in 2011/12 will continue to be calculated on the basis of the 4% CFR (capital financing requirement) method. This method will continue to be used in future years for capital expenditure incurred during or before 2006/07.

- For all borrowing and credit arrangements to fund capital expenditure incurred from 2007/08 onwards, the minimum revenue provision applied in 2011/12 will be calculated on the basis of the Asset Life method.

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 Members approve the Treasury Management Strategy 2011/12 as set out in this report.

9.2 Members approve the Minimum Revenue Provision Policy 2011/12.

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 2011

Estimate of Ratio of Financing Costs to Net Revenue Stream	6.4%
Estimate of the Incremental Impact of the New Capital Investment Decisions on the Council Tax (Band D)	£1.57
Estimate of Total Capital Expenditure to be Incurred	£2,804,000
Estimate of Capital Financing Requirement	£28,078,000
Operational Boundary	£30,762,000
Authorised Limit	£33,838,000
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	Japan
Denmark	Belgium	Kuwait
Finland	Hong Kong	UAE
France	Spain	
Germany		
Luxembourg		
Netherlands		
Norway		
Singapore		
Sweden		
Switzerland		
U.K.		
U.S.A.		