London Borough of Hammersmith & Fulham

AUDIT AND PENSIONS COMMITTEE

17th February 2011

LEADER

Wards
ALL

TREASURY MANAGEMENT STRATEGY REPORT

The report provides information on the Council's Treasury Management Strategy for 2011/12 including interest rate projections and borrowing and investment activity reports for the period April to December 2011.

The report seeks approval for borrowing limits and authorisation for the Director of Finance & Corporate Services to arrange the Council's cashflow, borrowing and investments in the year 2011/12.

CONTRIBUTORS
DFCS

Recommendations:

1. **To approve the future borrowing and investment strategies and authorise the Director of Finance and Corporate Services to arrange the Council's cashflow, borrowing and investments in 2011/12.**

2. **To approve the additions to the list of institutions to the Council's restricted lending list noted at 10.4.**

3. **In relation to the Council's overall borrowing for the financial year 2011/12, approve the Prudential Indicators as set out in Section 3 of this report.**

4. **To delegate future amendments to the credit criteria to Cabinet.**

1. Introduction

1.1. Background

Treasury management is defined as:

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

1.2 Statutory requirements

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

The Act therefore requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance subsequent to the Act and included as paragraph 9 of this report); this sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

The Department of Communities and Local Government has issued revised investment guidance which came into effect from April 2010. There were no major changes required over and above the changes already required by the revised CIPFA Treasury Management Code of Practice 2009.

1.3 Treasury Management Strategy for 2011/12

The strategy for 2011/12 in respect of the following aspects of the treasury management function is based upon the Treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor. The strategy covers:

- treasury limits in force which will limit the treasury risk and activities of the Council;
- prudential indicators
- the current treasury position;
- the borrowing requirements;
- prospects for interest rates;
- the borrowing strategy;
- the investment strategy;
- debt rescheduling;

1.4 Balanced Budget Requirement

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

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

2. Treasury Limits 2011/12 to 2013/14

- It is a statutory duty under S.3 of the Local Government Act 2003 and supporting regulations for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the "Authorised Limit".

- The Council must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax and council rent levels is 'acceptable'.

- Whilst termed an "Authorised Limit", the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and the two successive financial years.

2.1 Limits to Borrowing Activity

- The Authorised Limit – This represents the maximum amount the Council may borrow at any point in time in the year. It has to be set at a level the Council considers "prudent" and it needs to be set and revised by members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable and encompasses borrowing for temporary purposes. It is not a limit that is designed to be brought into consideration during the routine financial management of the authority. That is the purpose of the Operational Boundary.

- The Operational Boundary – This indicator is the focus of day to day treasury management activity within the authority. It is a means by which the authority manages its external debt to ensure that it remains within the self imposed Authorised Limit. Sustained breaches of the Operational Boundary would give an indication that the authority may be in danger of stepping beyond the Prudential boundaries it has set itself.

2.2 Interest Rate Exposures

Interest rate risk management is a key priority for local authority management. While fixed rate borrowing and investment can contribute significantly to reducing the uncertainty surrounding future interest rate scenarios, the pursuit of optimum performance may justify, or even demand, retaining a degree of flexibility through the use of variable interest rates on at least part of a treasury management portfolio. This is a best practice approach to treasury management and is to be encouraged to the extent that it is compatible with the effective management and control of risk.

a) Upper Limit on fixed rate exposure -– This indicator identifies a maximum limit for fixed interest rates based upon the debt position net of investments.

b) Upper Limit on variable rate exposure – This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments.

c) Total principal funds invested for periods longer than 364 days – These limits are set to reduce the need for early sale of an investment, and are based on the availability of investments after each year-end.

d) Maturity structures of borrowing – This indicator is designed to be a control over an authority having large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates. It is not necessary to include variable rate debt because local authorities do not face substantial refinancing risks. The indicator is, in effect, a limit on longer term interest rate exposure.

- This indicator gives the upper and lower limits for maturity structure of borrowing.

3. Prudential Indicators for 2010/11 – 2013/14

3.1 The Prudential Indicators in the table below are relevant for the purpose of setting an integrated treasury management strategy.

3.2 The Council is also required to indicate if it has adopted the revised 2009 CIPFA Code of Practice on Treasury Management. Council adopted this revised Code of Practice on 24th February 2010.

Table 1 - Prudential Indicators

Treasury Management Indicators	**2010/11 £000**	**2011/12 £000**	**2012/13 £000**	**2013/14 £000**
Authorised limit for external debt				
Borrowing	563,249	553,523	529,283	521,379
Other Long Term Liabilities	16,000	16,000	16,000	16,000
Total authorised limit	579,249	569,523	545,283	537,379
Operational boundary				
Borrowing	499,694	479,520	479,345	459,090
Other Long Term Liabilities	16,000	16,000	16,000	16,000

Total operational boundary	515,694	495,520	495,345	475,090
Upper limit for fixed rate exposure expressed as :- net principal re fixed rate borrowing/ investments	540,000	544,000	533,000	509,000
Upper limit for variable rate exposure expressed as :- net principal re variable rate borrowing /investments	108,000	108,800	106,600	101,800
Upper limit for total principal sums invested for over 364 days	20,000	20,000	20,000	20,000

Maturity structure of fixed rate borrowing during 2010/11	Upper Limit	Lower Limit
Under 12 months	15%	0%
12 months and within 24 months	15%	0%
24 months and within 5 years	60%	0%
5 years and within 10 years	75%	0%
10 years and above	100%	0%

4.Current Portfolio Position

4.1 The Council's treasury portfolio position at the 31 December 2010 is shown in the following table.

Table 2 – Current Debt Portfolio

		Principal		Ave. rate
		£000's	£000's	%
Fixed rate funding	PWLB*	475,520		
	Market	0	475,520	5.75
Variable rate funding	PWLB	0		
	Market	0	0	
Total Debt			475,520	5.75
Total Short Term Investments			93,700	1.03
Total Debt net of total Investments			381,820	

* Public Works Loan Board

4.2 The reason for the difference between the gross and net debt is because the Council has borrowed £77 million for the Decent Homes Initiative and expects this to be used by 31st March 2011. In addition, the Council is holding monies on behalf of Capital Ambition, West London Housing in addition to Section 106 planning money.

4.3 The split of Council's debt between the Housing Revenue Account and the General Fund is show below.

Table 3 – Council Debt split

	31st March 2010	31st March 2011(estimate)
HRA	404,634	414,829
GF	70,886	60,691
Total Debt	475,520	475,520

4.4 The General Fund Capital Financing Requirement (CFR) is £133 million as at 31/03/10 compared to £137 million as at 31/03/09 a reduction of £4 million. The HRA CFR is £405 million as at 31/03/10 compared to £353 million as at 31/03/09 an increase of £52 million. The increase in HRA CFR is due to the delivery of the decent homes programme. The total CFR is £538 million as at 31/03/10. The CFR represents the underlying need to borrow and is higher than the actual level of debt due to the temporary borrowing of internal resources.

4.5 It is estimated that the General Fund Capital Requirement (CFR) will be £127 million as at 31/03/11 compared to £133 million as at 31/03/10 a reduction of £6 million. The HRA CFR is estimated as £415 million as at 31/03/11 compared to £405 million as at 31/03/10 an increase of £10 million. The increase in HRA CFR is due to the delivery of the decent homes programme. The total estimate of CFR is £543 million as at 31/03/11.

5. Borrowing Requirement

5.1 The Council is currently exploring the setting up of a housing company which may result in a further increase in new borrowing in future years to enable the building of new dwellings.

Table 4 – Potential Borrowing Requirement

	2010/11 £'000	2011/12 £'000	2012/13 £'000	2013/14 £'000
	Actual	Estimate	Estimate	Estimate
New borrowing (including ALMO)	0	0	0	0
Maturing loans	0	16,000	174	20,255

5.2 Due to the debt reduction policy it is likely that replacement borrowing will not be required for the maturing loans in 2011/12 to 2013/14.

5.3 Under the capital finance regulations, local authorities are permitted to borrow up to three years in advance of need. This Council will only consider borrowing up to 1 year in advance of need as the borrowing requirement in later years is only an estimate at this stage. The reason for borrowing in advance is to take advantage of low long term interest rates. There is a short term cost to borrowing in advance of need as currently investment rates are considerably lower than long term borrowing rates. This will be evaluated before any decision is taken to borrow in advance of need.

5.4 Borrowing in advance of need increases the level of temporary investments and thus increases the risk of loss of investment principal. However, the Council has put in place a prudent methodology to minimise this risk, see paragraph 11.

6. Prospects for Interest Rates

6.1 The Council appointed Sector Treasury Services as treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. Appendix A draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. The following table gives the Sector central view:

6.2 Sector Bank Rate forecast for financial year ends (March)

- 2010/2011 0.50%
- 2011/2012 1.00%
- 2012/2013 2.25%
- 2013/2014 3.25%

There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected.

7. Borrowing Strategy

Sectors's forecast for PWLB borrowing rates is shown in the table below:

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Mar-13	Mar-14
Bank rate	0.50%	0.50%	0.50%	0.75%	1.00%	2.25%	3.25%
5yr PWLB rate	3.30%	3.30%	3.40%	3.50%	3.60%	4.30%	5.00%
10yr PWLB rate	4.40%	4.40%	4.40%	4.50%	4.70%	5.10%	5.40%
25yr PWLB rate	5.20%	5.20%	5.20%	5.30%	5.30%	5.50%	5.70%
50yr PWLB rate	5.20%	5.20%	5.20%	5.30%	5.30%	5.50%	5.70%

A more detailed forecast is included in appendix A

7.1 The Council's borrowing strategy will give consideration to new borrowing in the following order of priority:-

- The cheapest borrowing will be internal borrowing by running down cash balances and foregoing interest earned at historically low rates. However, in view of the overall forecast for long term borrowing rates to increase over the next few years, consideration will also be given to weighing the short term advantage of internal borrowing against potential long term costs if the opportunity is missed for taking market loans at long term rates which will be higher in future years.

- PWLB variable rate loans for up to 10 years.

- Long term fixed rate market loans at rates significantly below PWLB rates for the equivalent maturity periods (where available) and to maintaining an appropriate balance between PWLB and market debt in the debt portfolio.

- Fixed rate PWLB borrowing for periods under 10 years where rates are expected to be significantly lower than rates for longer periods. This offers a range of options for new borrowing which will spread debt maturities away from a concentration in longer dated debt.

- Rates are expected to gradually increase during the year so it should therefore be advantageous to time new borrowing for the start of the year.

7.2 **Sensitivity of the forecast** – In normal times the main sensitivities of the forecast are likely to be the two scenarios below. The Council 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 of sentiment:

- If it were felt that there was a significant risk of a sharp fall in long and short term rates, due to a marked increase of risks around relapse into recession or of risks of deflation, then long term borrowing will be postponed.

- If it were felt that there was a more significant risk of a sharp 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.

8. Annual Investment Strategy

8.1 The Council will have regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2009 CIPFA's Treasury Management in Public Services of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code").

Although the annual investment strategy has to be approved by full Council, it is proposed that amendments to the investment methodology are delegated to Cabinet to enable changes to be made on a timely basis to reflect changes in market conditions.

8.2 The Council's investments priorities are:-

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

The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Council is low in order to give priority to security of its investments

8.3 The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

8.4 Investment instruments identified for use in the financial year are listed below under the 'Specified' and 'Non Specified' Investment categories. Counterparty limits will be as set by Council.

8.5 The Council in conjunction with its treasury advisor Sector, will use Fitch, Moody's and Standard and Poor ratings plus data on movements in credit default swap to derive its credit criteria. Credit ratings alerts and changes are notified to treasury officers on a daily basis and these are acted upon immediately. In addition officers monitor the financial press and economic reports. The Council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service.

- If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn.

- In addition to the use of Credit Rating the Council will be advised of information in movements in Credit Default Swaps (CDSs) 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 Councils lending list. It should be noted that the Council is only monitoring CDS movements for information purposes, and is not actually purchasing any CDSs.

8.6 The DCLG guidance requires authorities to specify their minimum acceptable credit rating. The minimum ratings required by the Council are:

Fitch

Long Term	Short Term	Individual	Support
A-	F2	C	2

Moody's

Long Term	Short Term	Financial Strength
A3	P-2	C

S & P

Long Term	Short Term
A-	A-3

8.7 Country Limits

The Council 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) see Appendix B. This list will be added to, or reduced, by officers should ratings change in accordance with this policy.

9. Interest rate outlook for investments

9.1 Bank Rate has been unchanged at 0.50% since March 2009. Bank rate is forecast to commence rising in quarter 3 of 2011 and then to rise steadily from thereon. Bank Rate forecasts for financial year ends (March) are as follows:-

2010/11	0.50%
2011/12	1.00%
2012/13	2.25%
2013/14	3.25%

9.2 There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected.

9.3 The Council will avoid locking into longer term deals while investment rates are down at historically low levels unless exceptionally attractive rates are available with counterparties of particularly high creditworthiness which make longer term deals worthwhile and within the risk parameters set by this council.

9.4 For its cash flow generated balances, the Council will utilise its business reserve accounts, money market funds and short dates deposits (overnight to three months) in order to benefit from the compounding of interest.

The Council will report on its investment activity as part of a mid year review and at the end of the financial year as part of the Annual Outturn Report.

9.5 Specified Investments

A specified investment is defined in the guidance as an investment which satisfies the conditions set out below:

(a) The investment is denominated in sterling and any payments or repayments in respect of the investment are payable only in sterling.

(b) The investment is not a long-term investment (ie over 364 days)

(c) The investment does not involve the acquisition of share capital or loan capital in any body corporate

Types of specified investments include and may be used by the Council are:

Term deposit – UK government
Term deposits – other Local Authorities
Term deposits – banks and building societies
Money market funds
Callable deposits – under 1 year
Certificates of deposits - issued by banks and building societies.
UK Government Gilts
Treasury Bills

9.6 Non-Specified Investments

The Council has made no investments in non-specified investments to date. These are any investments not meeting the definition in para 9.5 above.

9.7 However if there was a core cash balance available after taking into account the cash flow requirements and the outlook for short–term interest rates then the following non-specified investments could be used after consultation with our Treasury Advisor.

- Term deposits with banks with maturities in excess of one year.
- Term deposits with building societies with maturities in excess of one year
- Term deposits with Local Authorities with maturities in excess of one year.
- Structured deposits.
- Bond Funds with AAA rating credit criteria
- Callable deposits in excess of one year
- Certificates of deposits - issued by banks and building societies in excess of one year.

- UK Government Gilts in excess of one year

10. Credit Criteria

10.1 Each week the Treasury Section receives an up to date list of the credit rating for individual counterparties from our treasury advisors. In addition to this if any changes in the credit rating of individual counterparties or in banking structures e.g. on mergers or takeovers occur during the month Sector e-mail the amendments to the Treasury Section on a daily basis and the section adds/deletes counterparties as appropriate to/from the approved counterparty list.

10.2 The banking sector is still a volatile area and the current policy is that whilst we maintain our full lending list in accordance with the methodology in approved by Council on the 24th February 2010 we have been operating a more **restricted lending list**, lending only to UK banks, other Local Authorities and AAA Money Market Funds. For illustrative purposes Appendix B is attached to show the countries and organisations on the lending list at the present time using the approved methodology.

10.3 However, it is part of the Treasury Management Code of Practise that the Council needs a sound diversification policy with high credit quality counterparties. Such a policy is needed to prevent overreliance on a small number of counterparties and should also consider country, sector and group limits. In addition, there is a possibility that within the next 12 months the government will lower its support to RBS, Lloyds Bank and NatWest and therefore they will no longer have the creditworthiness of the government itself. The effect of this means the credit rating of these banks will be lower as the rating agencies will rate these banks without the government guarantee, this in turn means the Council will have to reduce the amount and duration the Council can lend to these banks. It is therefore proposed that we expand our current restricted list and diversify our lending portfolio now to other highly credit rated banks within highly credit rated countries. This will enable the Council to spread its credit risk but still maintain a low risk investment strategy.

10.4 Below is the proposed list of banking institutions which it is recommended the Council now adds to its **restricted lending list** use as well as the UK banking institutions, the AAA Money Market Funds and other Local Authorities. All of which are on our current lending list maintained in accordance with the agreed methodology approved by Council on 24 February 2010 for convenience it is shown as Appendix C.

10.5 Added to this the Nat West Call Account that we presently use will be affected by the new FSA liquidity rules and it is likely that call account deposits with instant access will pay a much lower rate of interest, possibly below base rate, this will further reduce the Council's investment options.

10.6 The limits are driven by the methodology which is shown in full in Appendix C the maximum limits for these banks are shown in the table below. The limits can change if there are rating changes, however the maximum limit would never be more than £25 Million.

	Fitch	Moody's	S&P	Max Limit
Australia	AA+	Aaa	AAA	£'000
Australia & New Zealand Bank	AA-, F1+, B, 1	Aa1, P-1, B	AA, A-1+	25,000
Commonwealth Bank of Australia	AA, F1+, A/B, 1	Aa1, P-1, B	AA, A-1+	25,000
National Bank of Australia	AA,F1+, B, 1	Aa1, P-1, B	AA, A-1+	25,000
Westpac Bank Corporation	AA, F1+,A/B, 1	Aa1, P-1, B	AA, A-1+	25,000
Canada	AAA	Aaa	AAA	
Bank of Montreal	AA-, F1+, B, 1	Aa2, P-1, B-	A+, A-1,	20,000
Bank of Nova Scotia	AA-, F1+, B, 1	Aa1, P-1, B	AA-, A-1+	25,000
National Bank of Canada	A+,F1,B,2	Aa2, P-1, B-	A,A-1	20,000
Toronto Dominion Bank	AA-,F1+,B,1	Aaa, P-1, B+	AA-,A-1+	25,000
France	AAA	Aaa	AAA	
Societe Generale	A+, F1+, B/C, 1	Aa2, P-1, C+	A+, A-1	20,000
Germany	AAA	Aaa	AAA	
Deutsche Bank	AA-,F1+,B/C, 1	Aa3, P-1, C+	A+,A-1	20,000
Singapore	**AAA**	**Aaa**	**AAA**	
DBS Ltd	AA-, F1+, B, 1	Aa1, P-1, B	AA-, A-1+	25,000
Overseas Chinese Banking Corporation	AA-, F1+, B, 1	Aa1, P-1, B	A+, A-1	25,000
United Overseas Bank Ltd	AA-, F1+, B, 1	Aa1, P-1, B	A+, A-1	25,000

11. Nationalised Banks and Part Nationalised Banks

In the UK, the nationalised and part-nationalised banks have credit ratings which do not conform to the credit criteria usually used to identify banks which are of high credit worthiness, as they are no longer separate institutions in their own right. However, the Council has agreed to invest in these institutions as they are now recipients of an F1+ short term rating as they effectively take on the creditworthiness of the Government itself i.e. deposits made with them are effectively being made to the Government. They also have a support rating of 1; in other words, on both counts, they have the highest ratings possible.

12. Debt Rescheduling

12.1 The introduction by the PWLB in 2007 of a spread between the rates applied to new borrowing and repayment of debt, which has now been compounded since 20 October 2010 by a considerable further widening of the difference between new borrowing and repayment rates, has meant that PWLB to PWLB debt restructuring is now much less attractive than it was before both of these events. In particular, consideration would have to be given to the large premiums which would be incurred by prematurely repaying existing PWLB loans and it is very unlikely that these could be justified on value for money grounds if using replacement PWLB refinancing. However, some interest savings might still be achievable through using LOBO (Lenders Option Borrowing Option) loans, and other market loans, in rescheduling exercises rather than using PWLB borrowing as the source of replacement financing.

12.2 As short term borrowing rates will be considerably cheaper than longer term rates, there may be potential for some residual opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the size of premiums incurred, their short term nature, and the likely cost of refinancing those short term loans, once they mature, compared to the current rates of longer term debt in the existing debt portfolio. Any such rescheduling and repayment of debt is likely to cause a flattening of the Council's maturity profile as in recent years there has been a lean towards longer dated PWLB.

12.3 The reasons for any rescheduling to take place will include:

- The generation of cash savings and / or discounted cash flow savings
- Help fulfil the strategy outlined in paragraph 8 above; and
- Enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

13. Decent Homes Initiative

In 2005/06 DCLG awarded the Council £192 million for supported borrowing for Decent Home Initiative. This funding has been drawn down since 2005/06. There is a further borrowing requirement for the Decent Homes Initiative of £3.7 million in 2011/12.

14. **HRA Reform consultation**

The Government are currently considering the reform of the HRA. This would mean that central government may repay a significant portion of the Council's Housing debt. It is expected that the method used will be for the CLG to make a payment directly to the PWLB who will top slice all our PWLB loans in the ratio total debt repayment to total debt. These proposals are currently on hold and we are waiting for further announcements.

15. Investment Consultants and Investment Training

15.1 Sector Treasury Services Ltd were appointed on 1st February 2008 for a three year period following a tendering exercise. Sector provide interest rate forecasts, economic updates, strategy reviews, training for treasury management staff and advice on the formulation of suitable borrowing and investment strategies and advice on investment counterparty creditworthiness. As the Sector contract expires on 31st January 2011, a new tender process is currently underway.

15.2 The Council is a member of the CIPFA treasury management network which provides a forum for the exchange of views and training of treasury management staff independent of the treasury management consultants. It also provides a quality check on the services received from the consultants.

15.3 Treasury management staff are required to attend the CIPFA network meetings and Sector seminars and training events on a regular basis throughout the year to ensure that they are up to date at all times on developments in treasury management and continue to develop their expertise in this area.

16. Comments of the Director of Finance and Corporate Services

16.1 The comments of the Director of Finance and Corporate Services are contained within this report.

17. Comments of the Head of Legal Services

17.1 The statutory requirements are set out in the body of the report.

18. Comments of the Audit and Pensions Committee

18.1 TBA

LOCAL GOVERNMENT ACT 2000
LIST OF BACKGROUND PAPERS

No.	Description of Background Papers	Name/Ext. of Holder of File/Copy	Department/ Location
1	Borrowings and Investments Ledger	Rosie Watson Ext. 2563	Ground Floor Town Hall
2	CIPFA-Prudential Code - Accounting for Capital Finance	Rosie Watson Ext. 2563	Ground Floor Town Hall
3	Various Economic commentaries	Rosie Watson Ext. 2563	Ground Floor Town Hall

APPENDIX A Interest Rate Forecasts

The data below shows a variety of forecasts published by a number of institutions. The first three are individual forecasts including those of UBS and Capital Economics (an independent forecasting consultancy). The final one represents summarised figures drawn from the population of all major City banks and academic institutions.

The forecast within this strategy statement has been drawn from these diverse sources and officers' own views.

1. Individual Forecasts

Sector: interest rate forecast – 6.1.11

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
Bank rate	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.25%	2.75%	3.00%	3.25%	3.25%
3 month LIBID	0.60%	0.70%	0.80%	1.00%	1.25%	1.50%	1.75%	2.00%	2.50%	3.00%	3.25%	3.50%	3.50%
6 month LIBID	0.90%	1.00%	1.10%	1.20%	1.50%	1.80%	2.10%	2.40%	2.80%	3.20%	3.50%	3.80%	4.00%
12 month LIBID	1.40%	1.50%	1.60%	1.80%	2.10%	2.40%	2.70%	3.00%	3.20%	3.40%	3.65%	4.00%	4.20%
5yr PWLB rate	3.30%	3.30%	3.40%	3.50%	3.60%	3.80%	3.90%	4.10%	4.30%	4.60%	4.80%	4.90%	5.00%
10yr PWLB rate	4.40%	4.40%	4.40%	4.50%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%	5.40%	5.40%
25yr PWLB rate	5.20%	5.20%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.60%	5.70%	5.70%
50yr PWLB rate	5.20%	5.20%	5.20%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.60%	5.70%	5.70%

Capital Economics: interest rate forecast – 12.1.11

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.50%	2.00%
5yr PWLB rate	3.20%	3.20%	3.00%	2.75%	2.75%	2.90%	3.00%	3.20%	3.40%	3.60%	3.90%	4.20%
10yr PWLB rate	4.75%	4.75%	4.25%	3.75%	3.75%	3.75%	3.75%	3.75%	3.90%	4.00%	4.30%	4.60%
25yr PWLB rate	5.25%	5.25%	4.85%	4.65%	4.65%	4.65%	4.65%	4.65%	4.75%	4.85%	5.10%	5.30%
50yr PWLB rate	5.30%	5.30%	5.20%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.10%	5.20%	5.30%

UBS: interest rate forecast (for quarter ends) – 6.1.11

	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
Bank rate	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%
10yr PWLB rate	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%
25yr PWLB rate	5.25%	5.30%	5.35%	5.40%	5.45%	5.50%	5.55%	5.60%
50yr PWLB rate	5.35%	5.40%	5.45%	5.50%	5.55%	5.60%	5.65%	5.70%

2. Survey of Economic Forecasts

HM Treasury December 2010

The current Q4 2010 and 2011 forecasts are based on the December 2010 report. Forecasts for 2010 – 2014 are based on 32 forecasts in the last quarterly forecast – in November 2010.

BANK RATE FORECASTS		quarter ended		annual average Bank Rate			
	actual	Q4 2011		ave. 2011	ave. 2012	ave. 2013	ave. 2014
Median	0.50%	2.00%		0.90%	1.60%	2.40%	3.00%
Highest	0.50%	0.50%		2.10%	3.10%	3.60%	4.50%
Lowest	0.50%	0.80%		0.50%	0.50%	0.60%	1.20%

APPENDIX C

METHODOLOGY FOR ESTABLISHING CREDIT CRITERIA
The follow methodology has been used to establish the credit criteria for an organisation or group.

All Countries where investments are placed should have a minimum **Sovereign rating** of AA+

Exposure limit of £25 Million to be placed with any one country except the UK which would be unlimited.

The Council will use all 3 credit rating agencies Fitch, Moody's and Standard & Poor to derive its credit criteria. The methodology has a mathematical basis and gives a score to each of the ratings. An average score is then calculated for each of the constituent rating for Long Term, Short Term, Individual and Support. A sum of the averages is then taken and duration calculated based on this final value. The methodology is completely objective and mathematical, applying equal weight to each credit rating component.

The system also takes into account negative and positive rating watches and outlook.

The methodology applies a ranking and scoring procedure to the credit rating to obtain a number, based on all the credit ratings of every rating agency, which is then compared to the scoring bands.

Scoring procedure for the 3 Credit Rating Agencies

Long Term Ratings

Fitch		Moody's		S&P	
Rating	**Scoring**	**Rating**	**Scoring**	**Rating**	**Scoring**
AAA	1	Aaa	1	AAA	1
AA+	2	Aa1	2	AA+	2
AA	3	Aa2	3	AA	3
AA-	4	Aa3	4	AA-	4
A+	5	A1	5	A+	5
A	6	A2	6	A	6
A-	7	A3	7	A-	7

Short Term Ratings

Fitch		Moody's		S&P	
Rating	**Scoring**	**Rating**	**Scoring**	**Rating**	**Scoring**
F1+	1	-	-	A-1+	1
F1	2	P-1	2	A-1	2
F2	3	P-2	3	A-3	3

Only Fitch and Moody's use Individual Ratings

Individual Ratings

Fitch		Moody's	
Rating	**Scoring**	**Rating**	**Scoring**
-	-	A+	0.5
A	1	A	1
-	-	A-	1.5
A/B	2	B+	2
B	3	B	3
-	-	B-	3.5
B/C	4	C+	4
C	5	C	5

Support Ratings
As only Fitch uses Support ratings, there is no need to create any equivalency tables and we can use the rating directly into the calculation.

We then calculate the scoring for each counterparty on the scoring procedure.

Example

	Fitch				Moody's			S&P	
	Long Term	Short Term	Indiv	Support	Long Term	Short Term	FRS	Long Term	Short Term
Bank									
Austrialia and New Zealand Banking Group	AA-	F1+	B	1	Aa1	P-1	B	AA	A-1+
Scoring	4	1	3	1	2	2	3	3	1

The Average for Long Term Rating is Fitch 4, Moody's 2 and S&P 3 = 9
9 divided by 3 (the no. of agencies) = 3

The Average for Short Term Rating is Fitch 1, Moody's 2 and S&P 1 = 4
4 divided by 3 (the no. of agencies) = 1.333

The Average for Individual Rating is Fitch 3 and Moody's 3 = 6
6 divided by 2 (the no. of agencies) = 3

The average for Support Rating is Fitch 1 as it is the only agency that uses Support Ratings

The sum total of these averages = 3+1.333+3+1 = 8.333

The score is now placed within the predetermined bands.

Bands

Colour	Lower Boundary	Upper Boundary
Purple	4.00	8.50
Orange	8.50	10.50
Red	10.50	12.50
Green	12.50	14.50
No Colour	14.50	30.00

Where:-
Purple - Exposure limit of £25 Million with a maximum duration of 24 months.
Orange - Exposure limit of £25 Million with a maximum duration of 364 days.
Red – Exposure limit of £20 Million with a maximum duration of 6 months.
Green – Exposure limit of £10 Million with a maximum duration of 3 months
No Colour – 0 months duration

In the example a score of 8.33 would place the bank in the Purple band and gives it a suggested maximum duration of 24 months.

Credit Watch/Outlook Overlay

To take into account credit watch and outlooks from the three credit rating agencies an overlay has been developed which penalises a counterparty's score.

The methodology focuses just on the negative and positive outlooks and watches. Although stable, evolving and developing outlooks are still considered important when looking for a broader credit perspective, they can not be correlated with a direct impact in the change of counterparties score on the credit list.

Watches – are considered short term actions, where as **outlooks** are considered over a longer period of time.

To take account of the effect of a bank being on **negative watch**, one point is added to the score of the relevant credit rating e.g. if Moody's placed a bank's short term rating on negative watch, we would add one point to its score. The opposite is applied for positive watches, 1 point is deducted.

To take account of the effect of a bank being on **negative outlook**, then 1/2 point is added to the score of the relevant credit rating e.g. if Moody's placed a bank's short term rating on negative outlook, we would add 1/2 point to its score. The opposite is applied for positive outlooks, 1/2 point is deducted.

In the example above for Australia and New Zealand Group if Fitch had placed the bank on negative watch we would have added one point to the Fitch Long Term score to penalise the bank

The Average for Long Term Rating is Fitch 4 +1, Moody's 2 and S&P 3 = 9
9 divided by 3 (the no. of agencies) = 3.333

Then when the sum total had been added together it would have changed from 8.333 to 8.666 which would move it down to a lower band – Orange.

Banks that do not have a four way credit rating

To account for banks that do not have a full 4 way credit rating i.e. Long Term, Short Term, Individual and Support ,adjustments will be made to that bank's score.

By not having a full set of ratings it can skew the score for a bank making it higher as only 2 or 3 variables are being taken into account. See example below.

Example

	Fitch				Moody's			S&P	
	Long Term	Short Term	Indiv	Support	Long Term	Short Term	FRS	Long Term	Short Term
Bank									
Jyske Bank					Aa2	P-1	B-		
Scoring					4	2	3.5		

The average score is going to be:-

Long Term - 4, Short Term – 2, Individual 3.5, Support – 0 = 9.5

As this bank is only rated by Moody's and therefore does not have a four way approach. Currently they have a score of 9.5 putting them into the Orange band.

This colour of Orange is biased upwards as only 3 ratings have been taken into account, so it is intended to drop the colour of the bank by one band for every missing rating.

So if an bank only had a Long and Short Term rating, the initial colour would be reduced by 2 bands.

Applying CDS spreads to the credit list

CDS spreads are used as it has been proven that credit rating agencies lag market events and thus do not provide investors with an "up to date" picture of the credit quality of a particular bank.

CDS spreads are used as an overlay to the credit ratings. CDS spreads provide perceived market sentiment regarding the credit quality of an institution. Since they are traded instruments, they reflect the market perception related to that entity's credit quality. Credit ratings look at a firm's fundamentals i.e. balance sheet, income statement etc. and tend to focus on a longer term view of the firm.

It is important to note that not all entities will have an actively traded CDS spread.

Trend analysis

The weekly credit list provided by Sector shows the 1 week, 1 month and 3 month percentage change in a counterparty's CDS spread. This allows Treasury officers to monitor the short, medium and long term trends of CDS spreads.

Benchmark analysis

The benchmark CDS index which measures the "average" level of the most liquid financial CDS spreads in the market is the iTraxx Senior Financials Index. This is an index published by Markit who are the leading company in CDS pricing and valuation. The index is based on an equal weighting of CDS spreads of 25 European financial companies.

The iTraxx can be used to see where an institution's CDS spread is relative to that of the market and judge its creditworthiness in that manner, as well as looking at the credit rating.

Adjusted duration

The methodology employs the rule that if the CDS spread of a bank/building society is below or equal to the level of the iTraxx, then it is deemed "In Range." It retains its' colour and duration.

If the bank/building society's CDS spread is between the iTraxx level and the iTraxx level + 50bps, then it is deemed "Monitoring." When a bank/building society is "Monitoring" its colour and duration is reduced by one band.

If the bank/building society's CDS spread is above the iTraxx level + 50bps, then it is deemed "Out of Range" its colour becomes no colour and is removed from the list.

Exceptions to this methodology

Nationalised and Part Nationalised Banks

See paragraph 11.

In light of this the colour Blue is used, for UK nationalised or part nationalised banks
Exposure limit of £35 Million with a maximum duration of 364 days.

Government

Debt Management Office
Treasury Bills
Government Gilts

No maximum amount because if we have no capacity to place funds with other financial institutions we need to place them with the government.

Public Authorities

Unitary Authorities
Local Authorities
Borough and District Council’s
Met. Police
Fire and Police Authorities

These authorities do not have credit ratings but statute (LG Act 2003 s13) suggests that credit risk attached to these authorities is an acceptable one.

Exposure limit of £25 Million with a maximum duration of 364 days.

Money Market Funds

All funds have a AAA credit rating which have a 60 day weighted average maturity. These funds allow instant access to cash, and provide enhanced yield and security.

Exposure limit of £10 Million – no maximum duration as these are instant access funds.