Inverclyde council

AGENDA ITEM NO. 4

Report To:	**The Inverclyde Council**	**Date: 15 April 2010**
Report By:	**Corporate Director Regeneration & Environment**	**Report No: SL/LA/524/10**
Contact Officer:	**Sharon Lang**	**Contact No: 01475 712112**
Subject:	**Treasury Management Strategy Statement and Annual Investment Strategy - 2010/11 - 2012/13 - Remit from Policy & Resources Committee**	

1.0 PURPOSE

1.1 The purpose of this report is to request the Council to consider a remit from the Policy & Resources Committee of 30 March 2010.

2.0 SUMMARY

2.1 The Policy & Resources Committee on 30 March considered the attached report by the Chief Financial Officer on the Treasury Management Strategy Statement and Annual Investment Strategy for 2010/13, Treasury Policy Limits and the Council's Prudential and Treasury Management Indicators for the next three years. APPENDIX

3.0 DECISION OF POLICY & RESOURCES COMMITTEE

3.1 The Policy & Resources Committee decided:

(1) that the Treasury Management Strategy, Annual Investment Strategy, Treasury Policy Limits, Prudential and Treasury Management Indicators outlined in the report be remitted to The Inverclyde Council for approval; and
(2) that The Inverclyde Council be requested to adopt the clauses within the Financial Regulations, as set out in Appendix 1, the revised Treasury Management Policy Statement as set out in Appendix 2 and, in full, the revised CIPFA Treasury Management Code and CIPFA Prudential Code and to approve the list of Permitted Investments as set out in Appendix 5 (including those for the Common Good Fund).

4.0 RECOMMENDATION

4.1 The Council is asked to consider the remit from the Policy & Resources Committee.

Sharon Lang
Legal & Democratic Services

Inverclyde council

APPENDIX
AGENDA ITEM NO. 4

Report To:	**Policy & Resources Committee**	**Date:**	**30 March 2010**
Report By:	**Chief Financial Officer**	**Report No:**	**FIN/23/10/AP/KJ**
Contact Officer:	**Alan Puckrin**	**Contact No:**	**01475 712223**
Subject:	**TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY - 2010/11-2012/13**		

1.0 PURPOSE

1.1 The purpose of this report is to request a remit to the Full Council, for their approval, of the Treasury Management Strategy Statement and Annual Investment Strategy for 2010/13, Treasury Policy Limits, and the Council's Prudential and Treasury Management Indicators for the next 3 years.

2.0 SUMMARY

2.1 The report proposes the Council's Treasury Management Strategy and Annual Investment Strategy for 2010/13, Treasury Policy Limits, and Prudential and Treasury Management Indicators for the next 3 years.

2.2 The report includes changes to the governance and reporting arrangements for Treasury Management arising from revised versions of the CIPFA Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes, and the Prudential Code. These documents were revised by CIPFA following the Icelandic Banks situation in 2008, the "Risk and Return" report issued by the Audit Commission, and the "Local Authority Investments" report issued by the House of Commons Communities and Local Government Select Committee.

2.3 The Treasury Management Strategy, Annual Investment Strategy, Treasury Policy Limits, Prudential Indicators, and Treasury Management Indicators have been set based on the Council's current and projected financial position (including projected capital expenditure) and on expected interest rate levels.

3.0 RECOMMENDATIONS

3.1 It is recommended that the Committee remits to the Full Council, for their approval, the Treasury Management Strategy, Annual Investment Strategy, Treasury Policy Limits, Prudential Indicators, and Treasury Management Indicators outlined in the report.

3.2 It is also recommended that the Council be requested to adopt the clauses, within the Financial Regulations, as set out in Appendix 1, the revised Treasury Management Policy Statement as set out in Appendix 2, and, in full, the revised CIPFA Treasury Management Code and CIPFA Prudential Code as well as approving the list of Permitted Investments as set out in Appendix 5 (including those for the Common Good Fund).

Alan Puckrin
Chief Financial Officer

4.0 BACKGROUND

Revised CIPFA Treasury Management Code of Practice 2009

4.1 In the light of the Icelandic Banks situation in 2008, CIPFA has amended the CIPFA Treasury Management in the Public Services Code of Practice (the Code), Cross-Sectoral Guidance Notes and Guidance Notes, the Prudential Code, and the template for the revised Treasury Management Policy Statement. It is also a requirement of the Code that this Council should formally adopt the Code.

As the Code has been revised, the Council is asked to adopt the clauses as set out in Appendix 1, the revised Treasury Management Policy Statement as set out in Appendix 2, and, in full, the revised CIPFA Treasury Management Code and CIPFA Prudential Code.

4.2 The revised Code has emphasised a number of key areas including the following: -

a) All councils must formally adopt the revised Code and four clauses.
b) The strategy report will affirm that the effective management and control of risk are prime objectives of the Council's treasury management activities.
c) The Council's appetite for risk must be clearly identified within the strategy report and will affirm that priority is given to security of capital and liquidity when investing funds and explain how that will be carried out.
d) Responsibility for risk management and control lies within the organisation and cannot be delegated to any outside organisation.
e) Credit ratings should only be used as a starting point when considering risk. Use should also be made of market data and information, the quality financial press, information on government support for banks and the credit ratings of that government support.
f) Councils need a sound diversification policy with high credit quality counterparties and should consider setting country, sector and group limits.
g) Borrowing in advance of need is only to be permissible when there is a clear business case for doing so and only for the current capital programme or to finance future debt maturities.
h) The main annual treasury management reports must be approved by the Full Council.
i) There needs to be, at a minimum, a mid-year review of treasury management strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved.
j) Each council must delegate the role of scrutiny of treasury management strategy and policies to a specific named body.
k) Treasury management performance and policy setting should be subjected to prior scrutiny.
l) Members should be provided with access to relevant training.
m) Those charged with governance are also personally responsible for ensuring they have the necessary skills and training.
n) Responsibility for these activities must be clearly defined within the organisation.
o) Officers involved in treasury management must be explicitly required to follow treasury management policies and procedures when making investment and borrowing decisions on behalf of the Council (this will form part of the updated Treasury Management Practices).

4.3 This strategy statement has been prepared in accordance with the revised Code. Accordingly, the Council's Treasury Management Strategy will need to be approved annually by the Full Council and there will also be a mid-year report. 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.

4.4 It is proposed that the Council will adopt the following reporting arrangements in accordance with the requirements of the revised Code:

Area of Responsibility	Council/ Committee/ Officer	Frequency
Treasury Management Policy Statement (revised)	Policy & Resources Committee then Full Council	Initial adoption in 2010
Treasury Management Strategy / Annual Investment Strategy	Policy & Resources Committee then Full Council	Annually before the start of the year
Treasury Management Strategy / Annual Investment Strategy – mid-year report	Policy & Resources Committee then Full Council	Mid-year
Annual Treasury Outturn Report / Annual Investment Report	Policy & Resources Committee then Full Council	Annually by 30 September after the end of the year
Treasury Management Practices	Policy & Resources Committee	Every three years

Revised CIPFA Prudential Code

4.5 CIPFA has also issued a revised Prudential Code which primarily covers borrowing and the Prudential Indicators. Three of these indicators have now been moved from being Prudential Indicators to being Treasury Indicators:

- Authorised limit for external debt
- Operational boundary for external debt
- Actual external debt.

All indicators are, however, to be presented together as one suite. In addition, where there is a significant difference between the net and the gross borrowing position, the risks and benefits associated with this strategy should be clearly stated in the annual strategy.

Revised Investment Guidance

4.6 The Scottish Government recently issued draft investment regulations (The Local Government Investments (Scotland) Regulations 2010) and a Finance Circular which sets out the requirements to obtain the consent of Scottish ministers for making investments; these are intended to be approved for implementation from 1 April 2010.

4.7 The Local Government in Scotland Act 2003 and supporting regulations require the Council to ‘have regard to’ the Prudential Code for Capital Finance in Local Authorities’ published by CIPFA in 2009 and to set Prudential and Treasury Management Indicators for the next three years to ensure that the Council’s capital investment plans are affordable, prudent and sustainable. They also require the Council to have regard to the ‘Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes’ published by CIPFA in 2009 which require the Council to set out its treasury management strategy for borrowing and investment and how it will give priority to security and liquidity in managing its investments.

4.8 The proposed strategy for 2010/13 in respect of the following aspects of the treasury management function is based upon the officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury consultants.

The strategy covers:

- treasury limits in force which will limit the treasury risk and activities of the Council;
- Prudential and Treasury Management Indicators;
- the current treasury position;
- 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 the use of external service providers; and
- any extraordinary treasury issues.

4.9 It is a statutory requirement for the Council to produce a balanced budget. In particular, a local authority must 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 are affordable within the projected income of the Council for the foreseeable future.

4.10 Treasury Management is a complex area with its own terminology and acronyms. In order to aid the Committee's understanding a Glossary of Terms is attached as Appendix 6.

5.0 PROPOSED TREASURY STRATEGY, PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT INDICATORS

Treasury Limits For 2010/11 To 2012/13

5.1 It is a statutory duty under part 7 of the Local Government in Scotland Act 2003 and supporting regulations for the Council to determine and keep under review how much it can afford to allocate to capital expenditure. This amount is termed the "Affordable Capital Expenditure Limit".

5.2 The Council must have regard to the Prudential Code when setting the Affordable Capital Expenditure 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 levels is 'acceptable'.

5.3 Whilst termed an "Affordable Capital Expenditure Limit", the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability. The affordable capital expenditure limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.

Prudential and Treasury Management Indicators For 2010/11 To 2012/13

5.4 Inverclyde Council adopted the 2001 CIPFA Code of Practice on Treasury Management and this report recommends that the Council adopts the revised 2009 Code.

5.5 Members should note that, due to changes in accounting rules from 2009/10 onwards, the Prudential and Treasury Management Indicators include, where required, the effect of assets being provided to the Council under the PPP arrangements.

5.6 The main Prudential and Treasury Management Indicators are as follows:

	2009/10	2009/10	2010/11	2011/12	2012/13
	Estimate	**Probable Outturn**	**Estimate**	**Estimate**	**Estimate**
Capital Expenditure (Number 5 - Prudential Indicator)	£000	£000	£000	£000	£000
Capital Programme	25,669	17,714	26,384	35,957	45,712
PPP Schools (incl. accounting adjustments)	0	21,368	(419)	54,693	(1,531)
Total	25,669	39,082	25,965	90,650	44,181
Ratio of financing costs to net revenue stream (Number 1 - Prudential Indicator)					
Non – HRA	8.34%	7.88%	9.05%	11.78%	13.02%
Net borrowing requirement (Number 4 - Prudential Indicator)	£000	£000	£000	£000	£000
As At 31 March	(30,402)	(46,857)	(38,173)	(33,921)	(39,984)
Capital Financing Requirement as at 31 March (Number 6 - Prudential Indicator)	£000	£000	£000	£000	£000
Non – HRA	199,028	206,827	219,376	296,483	326,997
Upper limit for total principal sums invested for over 364 days (Number 14 - Treasury Management Indicator)	£10,000,000 *	£0	£10,000,000 *	£10,000,000 *	£10,000,000 *

* - Subject to Investment Regulations being introduced by the Scottish Government.

	2009/10	2009/10	2010/11	2011/12	2012/13
	Estimate	**Probable Outturn**	**Estimate**	**Estimate**	**Estimate**
Authorised limit for external debt (Number 7 - Treasury Management Indicator)	£000	£000	£000	£000	£000
Borrowing	222,911	204,005	218,270	242,925	278,175
Other long term liabilities	0	21,368	20,949	75,642	74,111
TOTAL	222,911	225,373	239,219	318,567	352,286
Operational boundary for external debt (Number 8 - Treasury Management Indicator)	£000	£000	£000	£000	£000
Borrowing	212,960	198,441	212,317	236,300	270,588
Other long term liabilities	0	21,368	20,949	75,642	74,111
TOTAL	212,960	219,809	233,266	311,942	344,699

	2010/11	2011/12	2012/13
	Estimate	**Estimate**	**Estimate**
Incremental impact of capital investment decisions			
Incremental increase in council tax (band D) per annum (Number 2 - Prudential Indicator)	£0.36	£0.05	£3.32
Upper limit for fixed interest rate exposure (Number 11 - Treasury Management Indicator)	120%	120%	120%
Upper limit for variable rate exposure (Number 12 - Treasury Management Indicator)	40%	40%	40%

5.7 The limits on the maturity of fixed rate borrowing during 2010/11 (Number 13 – Treasury Management Indicator) are as follows:

Maturity Structure	Upper Limit	Lower Limit	2009/10 Probable Outturn
Under 12 months	30%	0%	4.28%
12 months and within 24 months	30%	0%	3.49%
24 months and within 5 years	30%	0%	4.56%
5 years and within 10 years	30%	0%	10.49%
10 years and within 30 years	30%	0%	1.81%
30 years and within 50 years	40%	0%	31.68%
50 years and within 70 years	45%	0%	43.67%

Current Portfolio Position

5.8 The Council's treasury portfolio position at 17/2/2010 (Number 9 – Prudential Indicator) comprised:

		Principal		**Average Rate**
		£000	£000	
Fixed rate funding	PWLB	65,779		
	Market	36,000	101,779	4.244%
Variable rate funding	PWLB	0		
	Market	66,926	66,926	4.720%
			168,705	4.433%
Other long term liabilities			21,316	---
TOTAL DEBT			**190,021**	
TOTAL INVESTMENTS			**38,406**	**0.856%**

Borrowing Requirement

5.9 The Council's borrowing requirement is as follows:

	2008/09	2009/10	2010/11	2011/12	2012/13
	£000 Actual	£000 Projected	£000 Estimate	£000 Estimate	£000 Estimate
New borrowing	20,000	10,000	10,000	26,000	25,000
Alternative financing arrangements	0	0	0	0	0
Replacement borrowing	0	5,000	5,000	4,000	0
TOTAL	20,000	15,000	15,000	30,000	25,000

Treasury Policy Limits

5.10 In addition to the Prudential Indicators and Treasury Management Indicators, the Council has Policy Limits, as follows:

	2010/11	**2011/12**	**2012/13**	**2009/10**
	Estimate	**Estimate**	**Estimate**	**Probable Outturn**
Maximum Percentage of Debt Repayable In Any Year	25%	25%	25%	23.710%
Maximum Proportion of Debt At Variable Rates	40%	40%	40%	30.779%
Maximum Percentage of Debt Restructured In Any Year	30%	30%	30%	8.216%

Prospects For Interest Rates

5.11 The Council has appointed Sector Treasury Services Ltd as treasury consultants and part of their service is to assist the Council to formulate a view on interest rates. The table in 5.12 gives the Sector view.

5.12 Sector interest rate forecast – 22nd February 2010

	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Bank rate	0.50%	0.50%	0.50%	0.50%	1.00%	1.50%	2.00%	2.50%	3.00%	3.25%	3.75%	4.25%	4.50%
5yr PWLB rate	3.05%	3.10%	3.15%	3.20%	3.40%	3.65%	4.00%	4.30%	4.50%	4.65%	4.75%	4.80%	4.85%
10yr PWLB rate	4.35%	4.35%	4.45%	4.50%	4.60%	4.70%	4.75%	4.90%	4.95%	5.10%	5.10%	5.15%	5.15%
25yr PWLB rate	4.75%	4.75%	4.80%	4.85%	4.90%	5.00%	5.05%	5.10%	5.20%	5.30%	5.35%	5.35%	5.35%
50yr PWLB rate	4.75%	4.75%	4.80%	4.85%	4.90%	5.05%	5.10%	5.15%	5.15%	5.30%	5.30%	5.30%	5.30%

5.13 Appendix 3 explains the Economic Background affecting the proposed Treasury Management Strategy and Annual Investment Strategy.

Borrowing Strategy

5.14 Sector's forecast for the PWLB new borrowing rates are:

	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%
5yr PWLB rate	3.05%	3.10%	3.15%	3.20%	3.40%	4.50%	4.85%
10yr PWLB rate	4.35%	4.35%	4.45%	4.50%	4.60%	4.95%	5.15%
25yr PWLB rate	4.75%	4.75%	4.80%	4.85%	4.90%	5.20%	5.35%
50yr PWLB rate	4.75%	4.75%	4.80%	4.85%	4.90%	5.15%	5.30%

5.15 In view of the above forecast it is proposed that the Council's borrowing strategy 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.
- PWLB rates on loans of less than ten years duration are expected to be lower than longer term PWLB rates offering a range of options for new borrowing which will spread debt maturities away from a concentration in long dated debt.
- 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.
- Consideration will also be given to borrowing fixed rate market loans at 0.25%-0.50% below the PWLB target rate.

5.16 In normal circumstances the main sensitivities of the forecast are likely to be the two scenarios noted below. Officers, in conjunction with the treasury consultants, 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, 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.

5.17 <u>External v. Internal Borrowing</u>

Comparison of Gross and Net Debt Positions At Year-End	2008/09	2009/10	2010/11	2011/12	2012/13
	£000 Actual	£000 Projected	£000 Estimate	£000 Estimate	£000 Estimate
Actual External Debt (Gross)	186,431	168,706	178,676	204,597	229,368
Cash Balances	42,369	30,103	18,422	17,677	16,467
Net Debt	144,062	138,603	160,254	186,920	212,901

- The Council is currently projected to have a difference at the 2009/10 year-end of £30,103,000 between gross debt and net debt.
- The general aim of this treasury management strategy is to seek to reduce and then approximately maintain the difference between the two debt levels over the next three years in order to reduce the credit risk incurred by holding investments whilst meeting liquidity requirements and retaining flexibility over funding requirements. Measures taken in the last year have already reduced substantially the level of credit risk so another factor which will continue to be carefully considered is the difference between borrowing rates and investment rates (subject to continuing risk management and monitoring over investments).
- Over the next three years, investment rates are expected to continue to be below long term borrowing rates and so value for money considerations 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). This would maximise short term savings although the scope for such action is limited, given the Council's level of cash balances.
- However, short term savings by avoiding new long term external borrowing in 2010/11 will also be weighed against the potential for incurring additional long term extra costs by delaying unavoidable new external borrowing until later years when PWLB long term rates are forecast to be significantly higher.

- The Council has already undertaken early repayment of some external debt to the PWLB in order to reduce the difference between its gross and net debt positions as previously reported to the Policy & Resources Committee. However, the introduction by the PWLB of significantly lower repayment rates than new borrowing rates in November 2007 has meant that large premiums would be incurred by such action in the near term (based on current PWLB rates); such levels of premiums may not be justifiable on value for money grounds. This situation will be monitored in case the differential is narrowed by the PWLB or when repayment rates rise substantially.

5.18 Against this background, caution will be adopted with the 2010/11 treasury operations. The Chief Financial Officer will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to the Policy & Resources Committee.

5.19 Policy on Borrowing in Advance of Need

The Council does not and will not borrow more than its needs purely in order to profit from the investment of the extra sums borrowed. In accordance with the revised Treasury Management Code, any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Council can ensure the security of such funds.

In determining whether borrowing will be undertaken in advance of need the Council will:

- Consider the proposed definition of such borrowing within the draft Code on the Investment of Money By Scottish Local Authorities
- Ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to take funding in advance of need
- Ensure the ongoing revenue liabilities created, and the implications for the future plans and for the budgets have been considered
- Evaluate the economic and market factors that might influence the manner and timing of any decision to borrow
- Consider the merits and demerits of alternative forms of funding
- Consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use
- Consider the impact of borrowing in advance on temporarily (until required to finance capital expenditure) increasing investment cash balances and the consequent increase in exposure to counterparty risk and other risks and the level of such risks given the controls in place to minimise them.

The maximum extent to which borrowing in advance would be undertaken by this Council is the borrowing requirement identified above for 2010/2013.

Debt Rescheduling

5.20 The introduction of different PWLB rates on 1st November 2007 for new borrowing as opposed to early repayment of debt, and the setting of a spread between the two rates has meant that PWLB to PWLB debt restructuring is now much less attractive than before that date. Interest savings may still be achievable through using LOBOs (Lenders Option Borrowers Option) loans and other market loans in rescheduling exercises.

5.21 As short term borrowing rates are expected to be considerably cheaper than longer term rates, there are likely to be opportunities to generate savings by switching from long term debt to short term debt. These savings will, however, need to be considered in the light of 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.

5.22 Consideration will also be given to the potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on currently held debt.

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

- The generation of cash savings and/or discounted cash flow savings but at minimum risk;
- Helping to fulfil the strategy outlined above; and
- Enhancing the balance of the portfolio (amending the maturity profile and/or the balance of volatility).

5.24 There has been much discussion as to whether the size of spread set by the PWLB between their long term repayment and new borrowing rates should be revised downwards in order to help local authorities who may be dissuaded from using investment cash balances to repay long term borrowing and thereby reduce counterparty and interest rate risk exposure. The PWLB issued a consultation document with suggested options to revise the methodology used to calculate the early repayment rate. The consultation period ended in January 2010. The Council will monitor developments in this area and may amend its strategy if significant changes are introduced.

5.25 All rescheduling will be reported to the Policy & Resources Committee and the Full Council and will be within the Treasury Policy Limits.

Annual Investment Strategy

5.26 Investment Policy

The Council will have regard to the Local Government Investment (Scotland) Regulations 2010 and accompanying finance circular, the 2009 revised CIPFA Treasury Management in Public Services Code of Practice and Cross-Sectoral Guidance Notes ("the CIPFA TM Code") and the Audit Commission's report on Icelandic investments. The Council's investment 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 the security of its investments.

5.27 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.

5.28 There are a large number of investment instruments that the Council could use. The list of investment instruments proposed for possible use by the Council (including those for the Common Good Fund) are listed in Appendix 4 along with details of the risks from each type of investment. The list of proposed investments reflects a low risk appetite and approach to investments by the Council.

5.29 Counterparty limits will be as set through the Council's Treasury Management Practices.

5.30 Appendix 5 is a list of forecasts of investment balances.

5.31 Creditworthiness Policy

The Council 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. 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 (indicating the likelihood of ratings changes for a counterparty or the expected direction of ratings for a counterparty)
- CDS spreads to give early warning of likely changes in credit ratings
- Sovereign ratings to select counterparties from only the most creditworthy countries.

5.32 This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour code bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Council to determine the duration for investments and are therefore referred to as durational bands. This service gives a much improved level of security for its investments. It is also a service that the Council would not be able to replicate using in-house resources.

5.33 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 worldwide potential counterparties. The Council will therefore use counterparties within the following durational bands:

- No Colour Not to be used
- Green 3 months
- Red 6 months
- Orange 1 year
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Purple 2 years.

Members should note that these are the maximum periods for which any investment with a counterparty meeting the criteria would take place but subject to the Council's policy on Investment instruments.

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

5.35 All credit ratings are monitored on an ongoing basis. 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 immediately.
- In addition to the use of Credit Ratings the Council will be advised of information in movements in Credit Default Swap spreads against a benchmark (the iTraxx index) 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.

Sole reliance will not be placed on the use of this external service. The Council also uses (where available) market data and market information, information on government support for banks and the credit ratings of that government support.

5.36 Country Limits

It is proposed that the Council will only use approved counterparties either from the UK or from countries with a minimum sovereign credit rating of AA- from Fitch Ratings (or equivalent from other agencies if Fitch does not provide). Countries currently meeting this criterion include Australia, Canada, France, Germany, Sweden, the USA, and the UK.

5.37 Investment Strategy

The Bank Rate has been unchanged at 0.50% since March 2009. It is forecast to commence rising in quarter 1 of 2011 and then to rise steadily from thereon. Bank Rate forecasts for financial year ends (March) are as follows: -

- 2009/10 0.50%
- 2010/11 1.00%
- 2011/12 3.00%
- 2012/13 4.50%

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

5.38 Sector advise that, for 2010/11, clients should budget for an investment return of 0.60% on investments placed during the financial year.

5.39 Any decisions to lock in investments will need to take cognisance of the medium term cash flow forecasts for the Council.

5.40 Policy on Longer Term Investments

Until the new investment regulations take effect from 1.4.2010, investing by Scottish local authorities is limited to one year. This restriction will be removed from that date and this authority accordingly wishes to be able to make use of this new power at times when such investing is both appropriate and attractive. Regulations require that the risks of such investing should be explained. The longer cash is invested for, the longer the period during which an institution holding Council funds could potentially default. This Council will manage such risk exposure by requiring a higher level of creditworthiness for all institutions with which money is placed for periods in excess of one year. This higher level of creditworthiness will not be solely dependent on the use of credit ratings but will also take into account Credit Default Swap (CDS) spreads and other information.

5.41 In addition, longer term investments are subject to greater interest rate risk in as much as there is more potential during a longer period for interest rates to move unexpectedly compared to the expectations at the time the investment was made. This Council manages this risk by having a view of the future course of interest rates and then formulating a treasury management strategy accordingly which aims to maximise investment earnings consistent with control of risk. Longer term investing is particularly attractive in times when there is an expectation that interest rates will fall so that the Council can lock in a higher level of earnings than would be available from a series of shorter term investments successively renewed over that same period. It can also be attractive in times when the market is over-ambitious in its expectations of the speed with which interest rates will rise and is exposed to a fall back in rates when more realistic expectations eventually come to the fore.

5.42 The maximum period which this authority will invest for in excess of one year will be 1 year (i.e. a maximum investment period of 2 years).

5.43 The maximum value that will be invested for periods in excess of one year will be £10m.

5.44 End of Year Investment Report

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

Policy on Use of External Service Providers

5.45 The Council uses Sector Treasury Services as its external treasury management advisers and uses the services of brokers for investment deals as required.

5.46 The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

5.47 The Council also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

Policy on Scrutiny, Monitoring and Change of Investment Policies and Practices

5.48 The Policy & Resources Committee will undertake a detailed examination of the Treasury Management Practices (TMPs) of the Council. These set out all the policies and procedures in place to implement the treasury management strategy and the principles set out in the treasury management policy statement. They are intended to minimise the risk to the capital sum of investments and for optimising the return on the funds consistent with those risks. When it is satisfied with these TMPs it will pass a resolution to adopt them.

5.49 Any changes in the TMPs will be submitted to the Policy & Resources Committee for approval prior to implementation.

5.50 The Policy & Resources Committee will carry out monitoring of the TMPs by undertaking a regular overall review every 3 years.

5.51 A copy of the TMPs may be obtained Finance Services.

6.0 IMPLICATIONS

6.1 Legal: None.

6.2 Finance: Adopting the Treasury Strategy and the Investment Strategy for 2010/11 and the following two years will allow a balance to be maintained between opportunities to continue to generate savings for the Council and minimising the risks involved.

Financial Implications: None.

6.3 Human Resources: None.

6.4 Equalities: None.

7.0 CONSULTATIONS

7.1 This report has been produced based on advice from the Council's treasury consultants (Sector Treasury Services Limited).

8.0 LIST OF BACKGROUND PAPERS

8.1 CIPFA - Treasury Management in the Public Services – Code of Practice and Cross-Sectoral Guidance Notes – Second Edition 2009
CIPFA - Treasury Management in the Public Services – Guidance Notes For Local Authorities Including Police Authorities And Fire Authorities – Third Edition 2009
CIPFA – The Prudential Code for Capital Finance in Local Authorities – Fully Revised Second Edition 2009
Scottish Government – The Local Government Investments (Scotland) Regulations 2010 as proposed, along with proposed guidance and consent.

Appendix 1

CLAUSES PROPOSED FOR ADOPTION BY INVERCLYDE COUNCIL

CIPFA recommends that all public service organisations adopt, as part of their standing orders, financial regulations, or other formal policy documents appropriate to their circumstances, four clauses as set out in the Treasury Management in the Public Services Code of Practice as revised in 2009.

These clauses, as proposed for adoption by Inverclyde Council by inclusion in the Financial Regulations, are as follows:

"1. The Council will create and maintain, as the cornerstones for effective treasury management:
- A Treasury Management Policy Statement, stating the policies, objectives and approach to risk management of its treasury management activities
- Suitable Treasury Management Practices (TMPs), setting out the manner in which the Council will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

The content of the Policy Statement and TMPs will follow the recommendations contained in Sections 6 and 7 of the Code, subject only to amendment where necessary to reflect the particular circumstances of the Council. Such amendments will not result in the Council materially deviating from the Code's key principles.

2. The Full Council will receive reports on its treasury management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its TMPs.

3. The Council delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to the Policy & Resources Committee, and for the execution and administration of treasury management decisions to the Chief Financial Officer, who will act in accordance with the organisation's Policy Statement and TMPs and, if he/she is a CIPFA member, CIPFA's Standard of Professional Practice on Treasury Management.

4. The Council nominates the Policy & Resources Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies."

Appendix 2

PROPOSED TREASURY MANAGEMENT POLICY STATEMENT

CIPFA recommends that the Treasury Management Policy Statement adopts a particular form of words. It is therefore proposed that Inverclyde Council's Treasury Management Policy Statement is as follows:

"1. This organisation 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. This organisation 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. This organisation 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."

ECONOMIC BACKGROUND

The following economic background is based on information from the Council's treasury consultants, Sector Treasury Services Ltd:

1.0. Introduction

1.1. The credit crunch storm of August 2007 eventually fed through to the near collapse of the world banking system in September 2008. This then pushed most of the major economies of the world into a very sharp recession in 2009 accompanied by a dearth of lending from banks anxious to rebuild their weakened balance sheets. Many governments were forced to recapitalise and rescue their major banks and Central Banks precipitately cut their Central Bank rates to 0.10-1.00% in order to counter the recession.

1.2. The long awaited start of growth eventually came in quarter 3 of 2009 in the US and the EU but not until quarter 4 in the UK.

1.3. Inflation has plunged in most major economies and is currently not seen as being a problem over the next two years due to the large output gaps and high unemployment putting a lid on wage growth. In many countries there have been widespread pay freezes in 2009 and these are likely to be persistent for some time.

1.4. Deflation could become a threat in some economies if they were to go into a significant double dip recession.

1.5. Asian countries, especially China, are buoying world demand through their own stimulus measures.

1.6. There still needs to be a radical world rebalancing of excess savings rates by cash-rich Asian and oil-based economies and excess consumption rates in Western economies if the world financial system is not to avoid a potential rerun of this major financial crisis in years to come.

1.7. Most major economies have resorted to a huge expansion of fiscal stimulus packages in order to encourage a fast exit from recession. This, together with expenditure on direct support provided to ailing banks, has led to a drastic expansion in government debt levels which will take many years to eliminate and to restore the previous health of national finances.

2.0. Two growth scenarios

2.1. The current big issue is 'how quickly will the major world economies recover?' There is a sharp division of opinion on this question and a corresponding impact on forecasts.

3.0. Assuming strong recovery

3.1. If a strong recovery occurs then this is a normal cyclical recovery which will be strong in the major world economies. The US still has potential to add further fiscal stimulus in 2010 to ensure that strong recovery continues after the current round of stimulus measures end. Growth in the EU is likely to be strong in 2010 and not require such help.

3.2. In the UK GDP growth would almost get back to near the long term average of about 2.5% in 2011 (actual forecast is 2.26%) but is likely to peak in the first half of the year as inventory rebuilding and stimulus measures fade and fiscal contraction kicks in later in the year.

3.3. The economy will rebalance with strong growth in exports and import substitution helped by strong recovery in the EU and the rest of the world.

3.4. Sterling has depreciated by 25% since the peak in 2007 and is likely to stay weak.

3.5. Consumer spending – only a mediocre recovery is expected due to a steady increase in the savings ratio from +1.7% in 2008 to +6.2% in 2009 and to about 8% in 2011 as consumers pay down debt or build cash balances as an insurance against potential loss of employment. Consumer incomes will be held down by wage freezes and increases in taxation.

3.6. House price recovery is expected to persist helped by a low Bank Rate for a prolonged period; the peak to trough fall in house prices is now expected to be no more than 20%. House prices are forecast to rise by about 6% in 2010, and 3% in 2011; mortgage approvals will rise back to the level of 75,000-80,000 per month needed to ensure a continuation of a trend of rising house prices.

3.7. CPI inflation is expected to peak at nearly 4% in early 2010 after the rise in VAT in January but then to fall below 2% until the end of 2011. The forecast for average annual inflation for 2010 is 1.7% and for 2011 is 1.6%.

3.8. The current MPC attitude is one of hang on as long as possible before increasing the Bank Rate. The aim of this would be to try to ensure that growth gets going at a decent rate and also that the Bank Rate gets back towards the historic normal range of 4% - 5% before the next recession and that all assets purchased through Quantitative Easing have been sold off by then. The first Bank Rate increase is expected in Q4 2010.

3.9. If there is a change of Government in 2010 with a more aggressive fiscal approach then this could delay the timing of increases in the Bank Rate.

3.10. The fiscal deficit is 6.4% of GDP, about £90bn, which is expected to fall at £11bn per annum over eight years at currently planned rates. This is similar to the peak deficit of 7% in 1990s which was remedied to a surplus of 1.6% in the space of 6 years helped by strong, steady economic growth of 3% per annum supported by loose monetary policy that compensated for the fiscal squeeze.

3.11. The major risk to this scenario would be a lack of supply of bank credit. However, it is felt that the Bank of England is on alert to ensure that this does not happen and would continue various measures to assist the expansion of credit.

4.0 **Assuming weak recovery**

4.1 If a weak recovery occurs then this is not a normal business cycle but a balance sheet driven cycle. Over-borrowed banks, corporates and consumers are focused on shrinking their levels of borrowing to more viable and affordable levels and this balance sheet adjustment will take several years to be effected. Repayment of debt will therefore act as a major headwind slowing the required increase in demand in the economy. Consequently there will only be weak economic recovery over the next few years after the initial sharp inventory rebuilding rebound fades. GDP growth is forecast to rise to only 1% in 2010 and then to 1.3% in 2011.

4.2 Fiscal contraction will further dampen economic recovery driven by a strong political agenda to accelerate cuts in expenditure and increases in taxation after the general election in 2010.

4.3 The consumer savings ratio has risen sharply and will remain elevated so as to eliminate over-borrowing and to insure against people losing their jobs during this downturn. This will depress consumer expenditure, the main driver of the UK economy.

4.4 Growth will also be hampered by a reduced supply of credit from weakened banks compounded by weak demand for credit.

4.5 The eventual reversal of Quantitative Easing will take cash out of the economy and reduce demand in the economy.

4.6 Unemployment is likely to be around 2.5 million in 2010 but will then rise as public sector cuts in expenditure are implemented. Weak economic growth will mean that these elevated unemployment levels will take years to get back to more normal levels. High unemployment will also reduce tax income and increase expenditure on benefits and the costs of local authority services.

4.7 Inflation will not be a threat for several years as the current 6% output gap will take until 2014 to be eliminated.

4.8 CPI inflation will blip up to nearly 4% in early 2010 due to temporary effects but will then be on a strong downward trend. It is forecast to dip into negative territory for a limited period in mid 2011. The forecast for average annual inflation for 2010 is 2.1% and for 2011 is 0.1%.

4.9 There is no need for the MPC to change the Bank Rate from 0.5% in 2010 or 2011 and possibly for 5 years as they will need to counter the fiscal contraction which will dampen demand in the economy.

4.10 Long PWLB rates will FALL from current levels to about 4.25% in 2010 due to weak economic recovery and minimal inflation so that the real rate of return (net of inflation) on long gilts is healthy at these low levels. There will be a fall in equity prices from current levels to about 4,800 on FTSE 100 by the end of 2010 as growth disappoints investor expectations. Conversely there will be a rise in gilt prices and a fall in yields from current levels as investors' appetite for risk exposure wanes.

5.0 **Treasury Consultants' View**

5.1 The Council's Treasury Consultants, Sector, recognise that at the current time it is difficult to have confidence as to exactly how strong the UK economic recovery will prove to be. Both the above scenarios are founded on major assumptions and research which could or could not turn out to be correct.

5.2 Sector has adopted a more moderate view between these two scenarios outlined above i.e. a moderate return to growth.

5.3 There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas:

- Degree of speed and severity of fiscal contraction after the General Election.
- Timing and amounts of the reversal of Quantitative Easing.
- Potential changes in financial regulation which could require financial institutions to purchase and then hold a much higher level of government debt instruments which can then be quickly sold to meet sudden liquidity pressures experienced by such institutions if another financial crisis should occur.
- Speed of recovery of banks' profitability and balance sheet imbalances. Banks and building societies have borrowed £180bn from the Bank of England under the Special Liquidity Scheme which will need to be repaid by January 2012. If the wholesale funding market unfreezes by then, this will considerably ease the pressure on financial institutions facing significant challenges to their debt maturity profiles over the next few years.
- Changes in the consumer savings ratio.
- Rebalancing of the UK economy towards exporting and substituting imports.

5.4 The overall balance of risks is weighted to the downside i.e. the pace of economic growth disappoints and Bank Rate increases are delayed and/or lower.

5.5 There is an identifiable risk of a double dip recession and deleveraging (debt reduction) creating a downward spiral of falling demand, falling jobs and falling prices and wages leading to deflation but this is considered to be a small risk and an extreme view at the current time on the basis of current evidence.

5.6 Gilt yields, especially longer term ones, were held down artificially low due to the Bank of England's Quantitative Easing operations. £200bn of gilts, commercial bonds and paper have been purchased under this scheme which caused gilt prices to be inflated and so depressed yields during the period when purchases were being made. The MPC have, as at February 2010, indicated a pause in any further Quantitative Easing. Gilt yields have risen markedly during February 2010 on the back of an apparent end to further Quantitative Easing, concerns about the size of the Government deficit and the lack of a detailed plan as to how to reduce it.

5.7 A further factor which has put some upward pressure on UK gilt yields is the current concern over some Mediterranean countries in the EU running high annual government deficits as a percentage of their GDP and similar to the percentage deficit being run in the UK . This, though, is not expected to have a major impact on UK gilt yields as the UK is starting from a much stronger position than these countries due to its lower base of total government debt. The UK annual fiscal deficit is currently expected to be nearly 13% of GDP in 2009/10 at £178bn and to get back to under 6% in 2013/14 on current plans. Total Government debt as a percentage of GDP is expected to rise from 43% in 2007 to 75% in 2010 and 87% in 2011.

5.8 Gilt yields usually also come under upward pressure close to a General Election as a result of investor fears of the outcome of the election. They could also rise higher, or remain elevated, if there was a hung Parliament in 2010, or if the fiscal situation deteriorates further.

5.9 Looking beyond 2010, Sector's view is that the risks that long term gilt yields and PWLB rates will rise markedly are high due to the high volume of gilt issuance in this country and the high volume of debt issuance in other major Western countries.

Appendix 4

PERMITTED INVESTMENTS

The Council approves the following forms of investment instrument for use as Permitted Investments:

	Minimum Credit Criteria	Liquidity Risk	Market Risk	Max % of Total Investments	Max. Maturity Period
Deposits					
Debt Management Agency Deposit Facility (DMADF)	---	Term	No	Unlimited	6 Months
Term Deposits – Local Authorities	---	Term	No	80%	2 Years
Call Accounts – Banks and Building Societies	Sector Colour Category GREEN	Instant	No	Unlimited	Call Facility
Notice Accounts – Banks and Building Societies	Sector Colour Category GREEN	Notice Period	No	50%	3 Months
Term Deposits – Banks and Building Societies	Sector Colour Category GREEN	Term	No	80%	2 Years
Deposits With Counterparties Currently In Receipt of Government Support / Ownership					
Call Accounts – UK Nationalised/Part-Nationalised Banks	Sector Colour Category BLUE	Instant	No	Unlimited	Call Facility
Notice Accounts – UK Nationalised/Part-Nationalised Banks	Sector Colour Category BLUE	Notice Period	No	50%	3 Months
Term Deposits – UK Nationalised/Part-Nationalised Banks	Sector Colour Category BLUE	Term	No	80%	2 Years
Call Accounts - UK Government Support to the Banking Sector (implicit guarantee) – Abbey, Barclays, HBOS, Lloyds TSB, HSBC, Nationwide Building Society, RBS, Standard Chartered, Others Agreed by Government	Sector Colour Category GREEN	Instant	No	Unlimited	Call Facility
Notice Accounts - UK Government Support to the Banking Sector (implicit guarantee) – Abbey, Barclays, HBOS, Lloyds TSB, HSBC, Nationwide Building Society, RBS, Standard Chartered, Others Agreed by Government	Sector Colour Category GREEN	Notice Period	No	50%	3 Months
Term Deposits - UK Government Support to the Banking Sector (implicit guarantee) – Abbey, Barclays, HBOS, Lloyds TSB, HSBC, Nationwide Building Society, RBS, Standard Chartered, Others Agreed by Government	Sector Colour Category GREEN	Term	No	80%	2 Years

Non-Treasury Investments
In addition to the table of treasury investments above, the definition of "investments" under the Investment Regulations includes the following items:
"(a) All share holding, unit holding and bond holding, including those in a local authority owned company, is an investment.
(b) Loans to a local authority company or other entity formed by a local authority to deliver services, is an investment.
(c) Loans made to third parties are investments.
(d) Loans made by a local authority to another authority or harbour authority using powers contained in Schedule 3, paragraph 10 or 11 of the Local Government (Scotland) Act 1975 are not investments.
(e) Investment property is an investment."

The Council approves items in categories (a), (b), (c), and (e) above as Permitted Investments as set-out below:

	Minimum Credit Criteria	Liquidity Risk	Market Risk	Max % of Total Investments	Max. Maturity Period
Non-Treasury Investments					
(a) Share holding, unit holding and bond holding, including those in a local authority owned company	Assessment would be made of company in which any holding was to be made	Period of holding	Yes	10%	---
(b) Loans to a local authority company or other entity formed by a local authority to deliver services	Assessment would be made of company or entity to which any loan was to be made	Period of loan	No	10%	---
(c) Loans made to third parties	Assessment would be made of third party to which any loan was to be made	Period of loan	No	15%	---
(e) Investment property	Assessment would be made of property to be held as investment property	Period of holding	Yes	10%	---

In relation to the above, Members should note that the Council is unlikely to become involved with categories (a) or (b), will have loans to third parties (category (c)) arising from decisions on such loans made by the Council, and may have investment property due to the reclassification, for accounting purposes, of property held by the Council.

Permitted Investments – Common Good
The Common Good Fund's permitted investments are approved as follows:

	Minimum Credit Criteria	Liquidity Risk	Market Risk	Max % of Total Investments	Max. Maturity Period
Funds deposited with Inverclyde Council	---	Instant	No	50%	---
Share holding, unit holding and bond holding, including those in a local authority owned company	Assessment would be made of company in which any holding was to be made	Period of holding	Yes	10%	---
Investment property	Assessment would be made of property to be held as investment property	Period of holding	Yes	90%	---

Treasury Risks Arising From Permitted Instruments

All of the investment instruments in the above tables are subject to the following risks:

1. **Credit and counter-party risk**
   This is the risk of failure by a counterparty (bank or building society) to meet its contractual obligations to the Council particularly as a result of the counterparty's diminished creditworthiness, and the resulting detrimental effect on the Council's capital or current (revenue) resources. There are no counterparties where this risk is zero although AAA-rated organisations have a very high level of creditworthiness.

2. **Liquidity risk**
   This is the risk that cash will not be available when it is needed. While it could be said that all counterparties are subject to at least a very small level of liquidity risk as credit risk can never be zero, in this document, liquidity risk has been treated as whether or not instant access to cash can be obtained from each form of investment instrument. The column in the above tables headed as 'market risk' will show each investment instrument as being instant access, notice period i.e. money is available after the notice period (although it may also be available without notice but with a loss of interest), or term i.e. money is locked in until an agreed maturity date.

3. **Market risk**
   This is the risk that, through adverse market fluctuations in the value of the principal sums that the Council borrows and invests, its stated treasury management policies and objectives are compromised, against which effects it has failed to protect itself adequately. However, some cash rich local authorities may positively want exposure to market risk e.g. those investing in investment instruments with a view to obtaining a long term increase in value.

4. **Interest rate risk**
   This is the risk that fluctuations in the levels of interest rates create an unexpected or unbudgeted burden on the Council's finances, against which the Council has failed to protect itself adequately. This authority has set limits for its fixed and variable rate exposure in its Treasury Management Indicators in this report.

5. **Legal and regulatory risk**
   This is the risk that the Council, or an organisation with which it is dealing in its treasury management activities, fails to act in accordance with its legal powers or regulatory requirements, and that the Council suffers losses accordingly.

The risk exposure of various types of investment instrument can be summarised as: low risk = low rate of return, higher risk = higher rate of return.

For liquidity, the position can be summarised as: high liquidity = low return, low liquidity = higher returns.

Controls on Treasury Risks

1. **Credit and counter-party risk**
   This authority has set minimum credit criteria to determine which counterparties and countries are of high creditworthiness to enable investments to be made safely.

2. **Liquidity risk**
   This authority undertakes cash flow forecasting to enable it to determine how long investments can be made for and how much can be invested.

3. **Market risk**
   This authority does not purchase investment instruments which are subject to market risk in terms of fluctuation in their value.

4. **Interest rate risk**
   This authority manages this risk by having a view of the future course of interest rates and then formulating a treasury management strategy accordingly which aims to maximise investment earnings consistent with control of risk or alternatively, seeks to minimise expenditure on interest costs on borrowing.

5. **Legal and regulatory risk**
   This authority will not undertake any form of investing until it has ensured that it has all necessary powers and also complied with all regulations.

Unlimited Investments
Regulation 24 states that an investment can be shown in the above tables as being 'unlimited' in terms of the maximum amount or percentage of the total portfolio that can be put into that type of investment. However, it also requires that an explanation must be given for using that category.

The authority has given the following types of investment an unlimited category:

1. Debt Management Agency Deposit Facility (DMADF)
   This is considered to be the lowest risk form of investment available to local authorities as it is operated by the Debt Management Office which is part of H.M. Treasury i.e. the UK Government's AAA rating stands behind the DMADF. It is also a deposit account and avoids the complications of buying and holding Government issued treasury bills or gilts.

2. High Credit Worthiness Banks and Building Societies
   See paragraphs 5.31-5.33 for an explanation of this authority's definition of high credit worthiness. While an unlimited amount of the investment portfolio may be put into banks and building societies with high credit worthiness, the authority will seek to ensure diversification of its portfolio with the following limits:
   - Limit for any single institution (except Council's bankers): £15m
   - Limit for Council's bankers (Bank of Scotland): £50m
   - Limit for any one group of counterparties: £50m.

Objectives of Each Type of Investment Instrument
Regulation 25 requires an explanation of the objectives of every type of investment instrument which an authority approves as being 'permitted':

1. Deposits
   The following forms of 'investments' are actually more accurately called deposits as cash is deposited in an account until an agreed maturity date, or until the end of an agreed notice period, or is held at call.

   a) Debt Management Agency Deposit Facility (DMADF)
      This offers the lowest risk form of investment available to local authorities as it is effectively an investment placed with the Government. It is also easy to use as it is a deposit account and avoids the complications of buying and holding Government issued treasury bills or gilts. As it is low risk it also earns low rates of interest. It is, however, very useful for authorities whose overriding priority is the avoidance of risk at a time when many authorities are disappointed at the failure in 2008 of credit ratings to protect investors from the Icelandic bank failures and are both cautious about other forms of investing and are prepared to bear the loss of income to the treasury management budget compared to earnings levels in previous years. The longest term deposit that can be made with the DMADF is 6 months.

b) Term deposits with high credit worthiness banks and building societies
   See paragraphs 5.31-5.33 for an explanation of this authority's definition of high credit worthiness. This is the most widely used form of investing used by local authorities. It offers a much higher rate of return than the DMADF (dependent on term) and now that measures have been put in place to avoid over reliance on credit ratings, the Council feels much more confident that the residual risks around using such banks and building societies are at a low, reasonable and acceptable level. The Council will seek to ensure diversification of its portfolio of deposits as explained above. In addition, longer term deposits offer an opportunity to increase investment returns by locking in high rates ahead of an expected fall in the level of interest rates. At other times, longer term rates can offer good value when the markets incorrectly assess the speed and timing of interest rate increases. This form of investing therefore, offers a lot of flexibility and higher earnings than the DMADF. Where it is restricted is that once a longer term investment is made, that cash is locked in until the maturity date.

c) Notice accounts with high credit worthiness banks and building societies
   The objectives are as for 1.b) above but there is access to cash after the agreed notice period (and sometimes access without giving notice but with loss of interest). This generally means accepting a lower rate of interest than that which could be earned from the same institution by making a term deposit.

d) Call accounts with high credit worthiness banks and building societies
   The objectives are as for 1.b) above but there is instant access to recalling cash deposited. This generally means accepting a lower rate of interest than that which could be earned from the same institution by making a term deposit. However, there are a number of call accounts which at the time of writing, offer rates 2-3 times more than term deposits with the DMADF. Some use of call accounts is highly desirable to ensure that the authority has ready access to cash when needed to pay bills.

2. Deposits With Counterparties Currently In Receipt of Government Support/Ownership
   These institutions offer another dimension of creditworthiness in terms of Government backing through either direct (partial or full) ownership or the banking support package. The view of this Council is that such backing makes these banks attractive institutions with whom to place deposits, and that will remain our view if the UK sovereign rating were to be downgraded in the coming year.

   a) Term deposits with high credit worthiness banks which are fully or semi nationalised
      As for 1.b) above but Government ownership implies that the Government stands behind this bank and will be deeply committed to providing whatever support that may be required to ensure the continuity of that bank. This Council considers that this indicates a low and acceptable level of residual risk.

   b) Term deposits with high credit worthiness banks and building societies which are specified as being eligible for support by the UK Government
      As for 2.a) above but Government stated support implies that the Government stands behind eligible banks and building societies and will be deeply committed to providing whatever support that may be required to ensure the continuity of such institutions. This Council considers that this indicates a low and acceptable level of residual risk.

3. Non-Treasury Investments
   a) Share holding, unit holding and bond holding, including those in a local authority owned company
      The objectives for the holding of shares, units, or bonds (including those in a local authority owned company) will vary depending on whether the Council wishes to undertake actual investments in the market or has the holding as a result of a previous decision relating to the management or provision of Council services. This Council will not undertake investments in the market in shares, units, or bonds but may, if required, hold shares, units, or bonds arising from any decisions taken by the Council in relation to the management or provision of Council services.

b) Loans to a local authority company or other entity formed by a local authority to deliver services
Having established a company or other entity to deliver services, a local authority may wish to provide loan funding to assist the company or entity. Any such loan funding would be provided only after consideration of the reasons for the loan, the repayment period for the loan, and the likelihood that the loan would be able to be repaid by the company or entity.

c) Loans made to third parties
Such loans could be provided for a variety of reasons such as economic development or to assist local voluntary groups. Any such loan funding would be provided only after consideration of the reasons for the loan, the repayment period for the loan, and the likelihood that the loan would be able to be repaid by the third party concerned.

d) Investment property
An investment in property would give the Council exposure to risks such as market risk (movements in property prices), maintenance costs, tenants not paying their rent, leasing issues, etc. This Council does not undertake investments involving property but may have investment property due to the reclassification, for accounting purposes, of property held by the Council.

FORECASTS OF INVESTMENT BALANCES

Regulation 31 requires the Council to provide forecasts for the level of investments for the next three years, in line with the time frame of our capital investment programme. These forecasts are as follows:

INVESTMENT FORECASTS	2010/11	2011/12	2012/13
	Estimate	Estimate	Estimate
	£000	£000	£000
Cash balances managed in house			
1st April	30,103	18,422	17,677
31st March	18,422	17,677	16,467
Change in year	(11,681)	(745)	(1,210)
Average daily cash balances	24,263	18,050	17,072
Cash balances managed by cash fund managers			
1st April	0	0	0
31st March	0	0	0
Change in year	0	0	0
Average daily cash balances	0	0	0
TOTAL CASH BALANCES			
1st April	30,103	18,422	17,677
31st March	18,422	17,677	16,467
Change in year	(11,681)	(745)	(1,210)
Average daily cash balances	24,263	18,050	17,072
Holdings of shares, bonds, units (includes authority owned company)			
1st April	2	2	2
Purchases	0	0	0
Sales	0	0	0
31st March	2	2	2
Loans to local authority owned company or other entity to deliver services			
1st April	0	0	0
Advances	0	0	0
Repayments	0	0	0
31st March	0	0	0
Loans made to third parties			
1st April	321	556	490
Advances	300	0	0
Repayments	65	66	68
31st March	556	490	422
Investment properties			
1st April	6,179	6,179	6,179
Purchases	0	0	0
Sales	0	0	0
31st March	6,179	6,179	6,179

INVESTMENT FORECASTS (Continued)	2010/11	2011/12	2012/13
	Estimate	Estimate	Estimate
	£'000	£'000	£'000
TOTAL OF ALL INVESTMENTS			
1st April	36,065	25,159	24,348
31st March	25,159	24,348	23,070
Change in year	(11,446)	(811)	(1,278)

The movements in the forecast investment balances shown above are due largely to ongoing treasury management activity in accordance with the Council's treasury management strategy or, for loans made to third parties, in accordance with Council decisions made in respect of such loans.

The "holdings of shares, bonds, units (includes authority owned company)" are for Common Good whilst the Investment properties includes Council property and Common Good property.

TREASURY MANAGEMENT
GLOSSARY OF TERMS

Affordable Capital Expenditure Limit
The amount that the Council can afford to allocate to capital expenditure in accordance with the requirements of the Local Government in Scotland Act 2003 and supporting regulations.

Authorised Limit for External Debt
This is a limit for total Council external debt as set by the Council based on debt levels and plans.

Bank of England
The central bank for the UK with ultimate responsibility for setting interest rates (which it does through the Monetary Policy Committee or "MPC").

Bank Rate
The interest rate for the UK as set each month by the Monetary Policy Committee ("MPC") of the Bank of England. This was previously referred to as the "Base Rate".

Capital Expenditure
Expenditure on or for the creation of fixed assets that meets the definition of Capital Expenditure under the accounting rules as set-out in the annual Statement of Recommended Practice (SORP) and for which the Council are able to borrow.

Capital Financing Requirement
This is a Prudential Indicator that can be derived from the information in the Council's Balance Sheet. It generally represents the underlying need to borrow for capital expenditure.

CDS Spread
A CDS Spread or "Credit Default Swap" Spread is the cost of insuring against default by a Counterparty. Increases in the CDS Spread for a Counterparty may indicate concerns within the market regarding a Counterparty.

CIPFA
CIPFA is the Chartered Institute of Public Finance and Accountancy who produce guidance, codes of practice, and policy documents for Councils.

Consumer Prices Index
The Consumer Prices Index ("CPI") is a means of measuring inflation (as is the Retail Prices Index or "RPI"). The Monetary Policy Committee of the Bank of England set the Bank Rate in order to try to keep CPI at or close to the target set by the Government (currently the target is 2%). The calculation of the CPI includes many items of normal household expenditure but the calculation excludes some items such as mortgage interest payments and Council Tax.

Counterparty
Another organisation involved in a deal i.e. if the Council enters a deal with a bank then the bank would be referred to as the "Counterparty".

Credit Ratings
Credit ratings are indicators produced by a ratings provider (such as Fitch, Moody's or Standard & Poor's) that aim to give an opinion on the relative ability of a financial institution to meet its financial commitments. Credit ratings are not guarantees – they are opinions based on investigations and assessments by the ratings providers and they are regularly reviewed and updated. The Council makes use of credit ratings to determine which counterparties are appropriate or suitable for the Council to make deposits with.

European Central Bank
Sometimes referred to as "the ECB", the European Central Bank is the central bank for the Eurozone and is the equivalent of the Bank of England. The European Central Bank sets interest rates for the Eurozone.

Eurozone
The name given to the countries in Europe that have the Euro as their currency. Interest rates in the Eurozone are set by the European Central Bank. The Eurozone is comprised of the following 16 countries: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

Fed Rate
The interest rate for the US. Rates for the US are set by the Federal Reserve (the central bank for the US and the equivalent of the Bank of England).

Federal Reserve
Sometimes referred to as "the Fed", the Federal Reserve is the central bank for the US and is the equivalent of the Bank of England. The Federal Reserve sets interest rates for the US.

Fixed Rate Funding/Investments
Funding or investments where the interest rate that applies to payments or receipts of interest on the funding or investments is fixed and does not change.

Flat Yield Curve
A flat yield curve occurs where the yield for long-term investments is the same or similar to the yield for short-term investments – the period of the investment makes no or little difference to the yield on the investment.

Gilt Yields
A gilt yield is the effective rate of return that someone buying a gilt at the current market price will receive on that gilt. Since the market price of a gilt can vary at any time, the yield will also vary.

Gilts
Gilts are bonds (i.e. debt certificates) that are issued (i.e. sold) by the UK Government. When they issue gilts the Government sets the interest rate that applies to the gilt, sets when they will repay the value of the gilt, and it agrees to make interest payments at regular intervals until the gilt is repaid or redeemed. Gilts are traded in the financial markets with the price varying depending on the interest rate applicable to the gilt, when the gilt will be repaid (i.e. when it will mature), on base rate expectations, and on market conditions.

Gross Domestic Product
Gross Domestic Product ("GDP") is a measure of the output of goods and services from an economy.

Incremental Impact of Capital Investment Decisions
These are Prudential Indicators that reflect the impact on Council Tax of movements in projected and estimated capital expenditure within and between financial years.

Inflation
Inflation is the term used for an increase in prices over time. It can be measured in various ways including using the Consumer Prices Index ("CPI") or the Retail Prices Index ("RPI").

Inverted Yield Curve
An inverted or negative yield curve shows long-term investments having lower yields than short-term investments (an investor gets a better yield by investing for a shorter period).

Investment Regulations
The Local Government in Scotland Act 2003 allows the Scottish Ministers to introduce Regulations to extend and govern the rules under which Scottish Councils may invest funds. The Local Government Investments (Scotland) Regulations 2010 have recently been produced and are proposed to come into effect on 1st April 2010.

LIBID
This is the London Interbank Bid Rate – an interest rate that is used between banks when they wish to attract deposits from each other.

LIBOR
This is the London Inter Bank Offering Rate – an interest rate that is used as a base for setting interest rates for deals between banks.

LOBO
This is a form of loan that the Council has with some lenders. The term is short for the phrase "Lender Option/Borrower Option".

MPC
The MPC or Monetary Policy Committee is a committee of the Bank of England that meets each month (in a meeting over 2 days) to set the Bank Rate for the UK.

Negative Yield Curve
A negative or inverted yield curve shows long-term investments having lower yields than short-term investments (an investor gets a better yield by investing for a shorter period).

Net Borrowing Requirement
This is the difference between the Council's net external borrowing and its capital financing requirement. Under the Prudential Code the Council's net external borrowing should not, except in the short term, exceed its capital financing requirement. The Net Borrowing Requirement should therefore normally be a negative figure.

Operational Boundary
This is a level of debt set by the Council at lower than the Authorised Limit and which Council debt levels should not normally exceed during normal operations.

Positive Yield Curve
A positive yield curve shows long-term investments having higher yields than short-term investments (an investor gets a higher rate yield for investing for longer).

Prudential Code
Councils are required to comply with the CIPFA Prudential Code for Capital Finance in Local Authorities. These requirements include the production of Prudential Indicators. The Prudential Code was revised in November 2009 with the revisions including the reclassification of some Prudential Indicators as Treasury Management Indicators covered by the Treasury Management Code.

Prudential Indicators
Indicators set-out in the Prudential Code that will help Councils to meet requirements in relation to borrowing limits or which will help Councils demonstrate affordability and prudence with regard to their prudential capital expenditure.

PWLB
The Public Works Loan Board is a government agency and part of the Debt Management Office. The PWLB provides loans to local authorities and other specified bodies.

PWLB Rates
The interest rates chargeable by the Public Works Loan Board for loans. The rates for fixed rate loans are determined by the day on which the loan is agreed. The rates to be charged by the PWLB for loans are set each day based on gilt yields at the close of business on the preceding business day.

Quantitative Easing
The creation of money by a central bank (such as the Bank of England) in order to purchase assets from banks and companies and boost the supply of money in an economy.

Ratings
Ratings are indicators produced by a ratings provider (such as Fitch, Moody's or Standard & Poor's) that aim to give an indication of the financial or operational strength of entities including financial institutions and even countries. Ratings are not guarantees – they are opinions based on investigations and assessments by the ratings providers and they are regularly reviewed and updated. The Council makes use of credit ratings to determine which counterparties are appropriate or suitable for the Council to make deposits with.

Repo Rate
This is another name for the Bank Rate as set by the Monetary Policy Committee.

Retail Prices Index
The Retail Prices Index ("RPI") is a means of measuring inflation (as is the Consumer Prices Index or "CPI"). The calculation of the RPI includes most of the same items as the CPI as well as some items not included in the CPI such as mortgage interest payments and Council Tax whilst excluding items that are in the CPI such as charges for financial services.

Sector
Sector Treasury Services Limited who are the Council's treasury management consultants.

Treasury Management Code
This is the "Treasury Management in the Public Services: Code of Practice" and is a code of practice for Council treasury management activities. It is produced by CIPFA and was revised in November 2009 with changes including the transfer of some Prudential Indicators from the Prudential Code into the Treasury Management Code as Treasury Management Indicators.

Treasury Management Indicators
These are Prudential Indicators specifically relating to Treasury Management issues that were reclassified following the revision of the Prudential Code in November 2009.

Treasury Management Practices (TMPs)
This is a Council document that sets out Council policies and procedures for treasury management as required by the Treasury Management Code. The Council also agrees an annual treasury management strategy that is submitted to Committee in accordance with the Treasury Management Practices.

Variable Rate Funding/Investments
Funding or investments where the interest rate that applies to payments or receipts of interest on the funding or investments varies on an agreed basis.

Yield
The yield is the effective rate of return on an investment.

Yield Curve
A graph showing the yield on investments plotted against the maturity period for investments:

- A positive yield curve shows long-term investments having higher yields than short-term investments (an investor gets a higher rate yield for investing for longer).
- A negative or inverted yield curve shows long-term investments having lower yields than short-term investments (an investor gets a better yield by investing for a shorter period).
- A flat yield curve occurs where the yield for long-term investments is the same or similar to the yield for short-term investments – the period of the investment makes no or little difference to the yield on the investment.

Finance Services
Inverclyde Council
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