Appendix 9

# Treasury Management Strategy Statement and Investment Strategy 2012/13 to 2014/15

## 1 Summary

The Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Treasury Management Code) and the Prudential Code require fire authorities to determine the Treasury Management Strategy Statement (TMSS) and Prudential Indicators on an annual basis. The TMSS also includes the Annual Investment Strategy (AIS) that is a requirement of the Department for Communities and Local Government's Investment Guidance.

1.1 Treasury Management is about the management of risk. The Authority is responsible for its treasury decisions and activity. No treasury management activity is without risk.

1.2 As per the requirements of the Prudential Code, the Authority approved the adoption of the CIPFA Treasury Management Code at its meeting on 10 February 2010.

1.3 All treasury activity will comply with relevant statute, guidance and accounting standards.

1.4 For investments, the strategy takes account of the policy decision to build reserves for use in future years, recognising the potential for longer term investment opportunities.

1.5 The prudential indicators which are covered in Annex B are:

- net borrowing and the Capital Financing Requirement
- estimates of capital expenditure and capital financing
- ratio of financing costs to net revenue stream
- Capital Financing Requirement
- actual external debt
- incremental impact of capital investment decisions
- authorised limit and operational boundary for external debt
- adoption of the CIPFA Treasury Management Code
- gross and net debt

- upper limits for fixed interest rate exposure and variable interest rate exposure
- maturity structure of fixed rate borrowing
- credit risk
- upper limit for total principal sums invested over 364 days.

1.6 A glossary of terms is provided in Annex E.

1.7 **This strategy recommends the following approvals:**

- **Treasury Management Strategy and Annual Investment Strategy for 2012/13, although this would also be adopted for the rest of 2011/12**
- **Prudential Indicators for 2012/13, 2013/14 and 2014/15 – Annex B**
- **Minimum Revenue Provision (MRP) Statement – Section 10**
- **That the Authority reaffirms its commitment to sharing any capital losses on pooled cash balances on a pro rata basis, whilst any losses on deposits specifically made on behalf of the HFRA should be borne in full by the Authority.**

## 2 Capital Financing Requirement

2.1 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR). The CFR, together with Usable Reserves, are the core drivers of the Authority's Treasury Management activities.

2.2 The Authority's current level of debt and investments is set out at Annex A.

2.3 The Authority is able to borrow funds in excess of the current level of its CFR up to the projected level in 2014/15, although the Authority's CFR is estimated to fall in future years with the ongoing payment of Minimum Revenue Provision (MRP). The Authority is likely to only borrow in advance of need if it considers that the benefits of borrowing at interest rates now compared to where they are expected to be in the future, outweighs the current cost and risks associated with investing the proceeds until the borrowing is actually required.

2.4 The forecasted movement in the CFR in coming years is one of the Prudential Indicators (PIs). The movement in actual external debt and usable reserves combine to identify the Authority's borrowing requirement and potential investment strategy in the current and future years.

**Table 1: Balance Sheet Summary Analysis**

| | **31/03/12 Estimate £m** | **31/03/13 Estimate £m** | **31/03/14 Estimate £m** | **31/03/15 Estimate £m** |
|---|---|---|---|---|
| **Total Capital Financing Requirement** | 15.799 | 14.826 | 13.989 | 13.256 |
| **Less:**<br>External Borrowing – PWLB<br>Other Long Term Liabilities – finance leases | <br>-8.350<br>-0.862 | <br>-8.350<br>-0.521 | <br>-8.350<br>-0.252 | <br>-8.350<br>-0.066 |
| **Cumulative Maximum External Borrowing Requirement** | **6.587** | **5.955** | **5.387** | **4.840** |
| **Less:**<br>Balances & Reserves | -12.168 | -15.588 | -12.171 | -8.552 |
| **Cumulative Net Borrowing Requirement/(Investments)** | **-5.581** | **-9.633** | **-6.784** | **-3.712** |

2.5 Table 1 shows that the capital expenditure plans of the Authority cannot be funded entirely from sources other than external borrowing.

## 3 Interest Rate Forecast

3.1 The economic and interest rate forecast provided by the Authority's treasury management adviser, Arlingclose Ltd, is attached at Annex C. The Authority will reappraise its strategies from time to time in response to evolving economic, political and financial events.

## 4 Borrowing Strategy

4.1 Treasury management and borrowing strategies in particular continue to be influenced not only by the absolute level of borrowing rates but also the relationship between short and long term interest rates. The interest rate forecast provided in Annex C indicates that an acute difference between short and longer term interest rates is expected to continue. This difference creates a "cost of carry" for any new longer term borrowing where the proceeds are temporarily held as investments because of the difference between what is paid on the borrowing and what is earned on the investment. Whilst the cost of carry can be assumed to be a reasonably short-term issue since borrowing is often for longer dated periods (anything up to 50 years) it cannot be ignored against a backdrop of uncertainty and affordability constraints in the Authority's wider financial position.

4.2 As indicated in Table 1, the Authority has a gross borrowing requirement of £5.955m in 2012/13 but has sufficient balances and reserves to avoid the need for significant external borrowing. By essentially lending its own surplus funds to itself, the Authority is able to minimise borrowing costs and reduce overall treasury risk by reducing the level of its external investment balances.

## 5 Sources of Borrowing and Portfolio Implications

5.1 In conjunction with advice from its treasury advisor, the Authority will keep under review the following borrowing sources:

- Public Works Loan Board (PWLB)
- local authorities (including Hampshire County Council)
- commercial banks
- European Investment Bank
- money markets
- capital markets (stock issues, commercial paper and bills)
- structured finance
- leasing.

5.2 The cost of carry can encourage an increased reliance upon shorter dated and variable rate borrowing. This type of borrowing injects volatility into the debt portfolio in terms of interest rate risk but is counterbalanced by its affordability and alignment of borrowing costs with investment returns.

5.3 The Authority's PWLB borrowing portfolio of £8.35m has developed over a number of years since 1998, and the outstanding term remaining of 18 years relates to the estimated lives of the capital assets it has funded. The Authority has no exposure to shorter dated and variable rate borrowing. Its debt has a weighted average fixed interest rate of 4.71% and protects the Authority from the risk exposure to rising interest rates over the long term.

5.4 The debt portfolio's average borrowing term is kept under regular review by reference to the difference or spread between variable rate and longer term borrowing costs. A widening in the spread by 0.5% will result in an immediate and formal review of the borrowing strategy to determine whether a degree of exposure to shorter dated and variable rates is introduced.

## 6 Debt Rescheduling

6.1 The Authority's debt portfolio can be restructured by prematurely repaying loans and refinancing them on similar or different terms to achieve a reduction in risk and/or savings in interest costs.

6.2 The lower interest rate environment and changes in the rules regarding the premature repayment of PWLB loans has adversely affected the scope to undertake meaningful debt restructuring although occasional opportunities arise. The rationale for undertaking any debt rescheduling would be one or more of the following:

- savings in risk adjusted interest costs
- rebalancing the interest rate structure of the debt portfolio
- changing the maturity profile of the debt portfolio.

6.3 Borrowing and rescheduling activity will be reported to the Authority in the Annual Treasury Management Report and the regular treasury management reports presented to the Authority.

## 7 Annual Investment Strategy

7.1 In accordance with Investment Guidance issued by the Department for Communities and Local Government (DCLG) and best practice, the Authority's primary objective in relation to the investment of public funds remains the security of capital. The liquidity or accessibility of the Authority's investments followed by the yields earned on investments are important but secondary considerations.

7.2 Credit markets remain in a state of distress as a result of the excessive and poor performing debt within the financial markets. In some instances, Greece and Italy being the most notable examples, the extent and implications of the debt it has built up have led to a sovereign debt crisis and a banking crisis with the outcome still largely unknown. It is against this backdrop of uncertainty that the Authority's investment strategy is framed.

7.3 Investments are categorised as "Specified" or "Non-Specified" within the investment guidance issued by the DCLG. Specified investments are sterling denominated investments with a maximum maturity of one year. They also meet the "high credit quality" as determined by the Authority and are not deemed capital expenditure investments under Statute. Non-specified investments are, effectively, everything else.

7.4 The types of investments that will be used by the Authority and whether they are specified or non-specified are as follows:

**Table 2: Specified and Non-Specified Investments**

| **Investment** | Specified | Non-Specified |
|---|---|---|
| Term deposits with banks and building societies | ✓ | ✓ |
| Term deposits with other UK local authorities | ✓ | ✓ |
| Certificates of deposit with banks and building societies | ✓ | ✓ |
| Gilts | ✓ | ✓ |
| Treasury Bills (T-Bills) | ✓ | × |
| Bonds issued by Multilateral Development Banks | ✓ | ✓ |
| Local Authority Bills | ✓ | × |
| Commercial Paper | ✓ | × |
| Corporate Bonds | ✓ | ✓ |
| AAA rated Money Market Funds | ✓ | × |
| Other Money Market and Collective Investment Schemes | ✓ | ✓ |
| Debt Management Account Deposit Facility | ✓ | × |

7.5 A number of changes have been implemented to the investment strategy for 2012/13 in response to changes in the DCLG Guidance and evolving conditions in financial markets. This results in the inclusion of corporate bonds which the DCLG have indicated will become an eligible non-capital investment from 1 April 2012. However, the principal amendments are in relation to the individual institutions with which the Authority is prepared to lend its funds.

7.6 The Authority and its advisors, Arlingclose Ltd, select countries and financial institutions after analysis and ongoing monitoring of:

- published credit ratings for financial institutions (minimum long term rating of A- or equivalent for UK counterparties; AA+ or equivalent for non-UK sovereigns) – this is lower than the A+ minimum adopted in 2011/12 and is in response to downgrades in credit ratings below A+ of many institutions considered to be systemically important to the UK financial system
- sovereign support mechanisms
- credit default swaps (where quoted)
- share prices (where available)
- economic fundamentals, such as a country's net debt as a percentage of its GDP
- corporate developments, news, articles, market sentiment and momentum
- subjective overlay – or, put more simply, common sense.

Any institution can be suspended or removed should any of the factors identified above give rise to concern.

The countries and institutions that meet the criteria for term deposits, Certificates of Deposit (CDs) and call accounts are included in Annex D. It should be noted that given increasing stress in financial markets and expansion of risks presented by the crisis in the Eurozone, the Authority currently restricts its cash investments to UK banks, building societies, and other UK local authorities, and that Annex D sets out a wider list which would be appropriate if conditions were to change over the course of 2012/13 and investment counterparty risks were to reduce significantly.

It remains the Authority's policy to make exceptions to counterparty policy established around credit ratings, but this is conditional and directional. What this means is that an institution that meets certain criteria may nonetheless still be suspended, but institutions not meeting the criteria will not be added.

7.7 **Authority's Banker** – The Authority banks with NatWest. At the current time, it meets the minimum credit criteria of A- (or equivalent) long term. Even if the credit rating falls below the Authority's minimum criteria, NatWest will continue to be used for short term liquidity requirements (overnight and weekend investments) and business continuity arrangements.

## 8 Investment Strategy

8.1 With short term interest rates low for even longer, an investment strategy will typically result in a lengthening of investment periods, where cash flow permits, in order to lock in higher rates of acceptable risk adjusted returns. The problem in the current environment is finding an investment counterparty providing acceptable levels of counterparty risk.

8.2 In order to diversify an investment portfolio largely invested in cash, investments will be placed with a range of approved investment counterparties in order to achieve a diversified portfolio of prudent counterparties, investment periods and rates of return. Maximum investment levels with each counterparty will be set to ensure prudent diversification is achieved.

8.3 The Investment Strategy will provide flexibility to invest cash for periods of up to 364 days in order to access higher investment returns in the current low interest rate environment, although lending to UK local authorities can be for up to two years. This will be shortened in respect of those institutions with a higher perceived credit risk, based on the creditworthiness criteria outlined in paragraph 7.6. For example, new investment deposits with banks and building societies are restricted to periods of up to 3 months at the present time.

8.4 Cash investments with longer than 364 days to maturity will be restricted to a maximum of £2m, with a maximum investment being placed with one institution of £1m.

8.5 Any residual balances will be invested with the County Council, earning interest based on the Bank of England's base rate. When the position is overdrawn, the interest rate payable is similarly based on the Bank of England's base rate.

## 9 The Use of Financial Instruments for the Management of Risks

9.1 Currently, fire authorities' legal power to use derivative instruments remains unclear. The General Power of Competence enshrined in the Localism Bill is not sufficiently explicit. Consequently, the Authority does not intend to use derivatives.

9.2 Should this position change, the Authority may seek to develop a detailed and robust risk management framework governing the use of derivatives, but this change in strategy will require the Authority's approval.

**10 2012/13 Minimum Revenue Provision Statement**

10.1 The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 (SI 2008/414) place a duty on fire authorities to make a prudent provision for debt redemption. Guidance on Minimum Revenue Provision has been issued by the Secretary of State and fire authorities are required to "have regard" to such Guidance under section 21(1A) of the Local Government Act 2003.

10.2 The four MRP options available are:

Option 1: Regulatory Method
Option 2: CFR Method
Option 3: Asset Life Method
Option 4: Depreciation Method

*NB This does not preclude other prudent methods.*

10.3 MRP in 2012/13: Options 1 and 2 may be used only for supported expenditure which is where the borrowing costs are supported by extra revenue grant from the Government. Methods of making prudent provision for self financed expenditure include Options 3 and 4 (which may also be used for supported expenditure if the Authority chooses).

10.4 The MRP Statement will be submitted to the Authority before the start of the 2012/13 financial year. If it is ever proposed to vary the terms of the original MRP Statement during the year, a revised statement should be put to the Authority at that time.

10.5 The Authority will apply Option 1/Option 2 in respect of supported capital expenditure and Option 3/Option 4 in respect of unsupported capital expenditure.

And

MRP in respect of leases brought on Balance Sheet under the International Financial Reporting Standards (IFRS) based Accounting Code of Practice will match the annual principal repayment for the associated deferred liability.

## 11 Monitoring and Reporting on the Treasury Outturn and Prudential Indicators

11.1 Treasury activity is monitored quarterly and reported internally to the Treasurer. The Prudential Indicators will be monitored through the year by the Treasurer and reported as set out below:

The Treasurer will report to the Authority on treasury management activity / performance and Prudential Indicators as follows:
(a) a mid-year and year end review of treasury activity against the strategy approved for the year.
(b) The Authority will produce an outturn report on its treasury activity no later than 30 September after the financial year end.
(c) Finance & General Purposes Committee will be responsible for the scrutiny of treasury management activity and practices.

## 12 Other Items

12.1 Training

CIPFA's Code of Practice requires the *responsible officer,* which is the Treasurer, to ensure that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities.

A treasury management workshop jointly presented by the Treasurer and Arlingclose on 31 January 2012 provided members with an update in treasury matters.

The training needs of the Authority's treasury management staff are subject to regular review.

12.2 Investment consultants

The Treasurer uses Arlingclose Ltd as external treasury advisers for information, advice and assistance relating to borrowing and investment.

## Existing Debt and Investment Portfolio Position

| | 31 December 2011<br>Actual Portfolio<br>£m |
|---|---|
| **External Borrowing:** | |
| Fixed Rate – PWLB | -8.350 |
| Fixed Rate – Market | 0 |
| Variable Rate – PWLB | 0 |
| Variable Rate – Market | 0 |
| **Total External Borrowing** | -8.350 |
| **Other Long Term Liabilities:** | |
| - Finance Leases | -0.862 |
| **Total Gross External Debt** | -9.212 |
| **Investments:** | |
| *Managed in-house* | |
| - Lending to HCC | 7.143 |
| - Lending to other UK local authorities | 0.750 |
| - Lending to UK banks & building societies | 4.000 |
| **Total Investments** | 11.893 |

# Prudential Indicators 2012/13 – 2014/15

## 1 Background

There is a requirement under the Local Government Act 2003 for local authorities to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the "CIPFA Prudential Code") when setting and reviewing their Prudential Indicators.

## 2 Net Borrowing and the Capital Financing Requirement

This is a key indicator of prudence. In order to ensure that over the medium term net borrowing will only be for a capital purpose, the Fire Authority should ensure that the net external borrowing does not, except in the short term, exceed the total of the Capital Financing Requirement (CFR) in the preceding year plus the estimates of any additional increases to the CFR for the current and next two financial years.

The Treasurer reports that the Authority had no difficulty meeting this requirement in 2011/12, nor are there any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

## 3 Estimates of Capital Expenditure and Capital Financing

3.1 This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council Tax.

| **Capital Expenditure** | **2012/13 Estimate £m** | **2013/14 Estimate £m** | **2014/15 Estimate £m** |
|---|---|---|---|
| **Total** | **3.912** | **7.762** | **5.445** |

3.2 Capital expenditure will be financed or funded as follows:

| **Capital Financing** | **2012/13 Estimate £m** | **2013/14 Estimate £m** | **2014/15 Estimate £m** |
|---|---|---|---|
| Capital receipts | 1.052 | 3.228 | - |
| Government grants | 2.082 | 2.083 | 2.083 |
| Capital payments reserve | - | 1.721 | 2.632 |
| Revenue contributions | 0.778 | 0.730 | 0.730 |
| **Total** | **3.912** | **7.762** | **5.445** |

## 4 Ratio of Financing Costs to Net Revenue Stream

4.1 This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs. The definition of financing costs is set out in the Prudential Code.

4.2 The ratio is based on costs net of investment income.

| Ratio of Financing Costs to Net Revenue Stream | 2012/13 Estimate % | 2013/14 Estimate % | 2014/15 Estimate % |
|---|---|---|---|
| **Total** | **2.1** | **2.0** | **1.7** |

## 5 Capital Financing Requirement

5.1 The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose. The calculation of the CFR is taken from the amounts held in the Balance Sheet relating to capital expenditure and its financing.

| Capital Financing Requirement | 31/03/2013 Estimate £m | 31/03/2014 Estimate £m | 31/03/2015 Estimate £m |
|---|---|---|---|
| **Total** | **14.826** | **13.989** | **13.256** |

## 6 Actual External Debt

6.1 This indicator is obtained directly from the Authority's balance sheet. It is the closing balance for actual gross borrowing plus other long-term liabilities. This indicator is measured in a manner consistent for comparison with the Operational Boundary and Authorised Limit.

| Actual External Debt as at 31/03/2011 | £m |
|---|---|
| Borrowing | 8.350 |
| Other Long-term Liabilities – finance leases | 0.910 |
| **Total** | **9.260** |

## 7 Incremental Impact of Capital Investment Decisions

7.1 This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax. The incremental impact is calculated by comparing the total revenue budget requirement of the current approved capital programme with an equivalent calculation of the revenue budget requirement arising from the proposed capital programme.

| Incremental Impact of Capital Investment Decisions | 2012/13 Estimate £ | 2013/14 Estimate £ | 2014/15 Estimate £ |
|---|---|---|---|
| **Increase in Band D Council Tax** | **0.84** | **1.12** | **1.15** |

## 8 Authorised Limit and Operational Boundary for External Debt

8.1 The Authority has an integrated treasury management strategy and manages its treasury position in accordance with its approved strategy and practice. Overall borrowing will therefore arise as a consequence of all the financial transactions of the Authority and not just those arising from capital spending reflected in the CFR.

8.2 The **Authorised Limit** sets the maximum level of external borrowing on a gross basis (i.e. not net of investments) for the Authority. It is measured against all external borrowing items on the Balance Sheet, i.e., long and short term borrowing, overdrawn bank balances and long term liabilities. This Prudential Indicator separately identifies borrowing from other long term liabilities such as finance leases. It is consistent with the Authority's existing commitments, its proposals for capital expenditure and financing and its approved treasury management policy statement and practices.

8.3 The Authorised Limit has been set on the estimate of the most likely, prudent but not worst case scenario with sufficient headroom over and above this to allow for unusual cash movements.

8.4 The Authorised Limit is the statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit).

| Authorised Limit for External Debt | 2012/13 Estimate £m | 2013/14 Estimate £m | 2014/15 Estimate £m |
|---|---|---|---|
| Borrowing | 20.5 | 19.7 | 19.1 |
| Other Long-term Liabilities – finance leases | 0.5 | 0.3 | 0.1 |
| **Total** | **21.0** | **20.0** | **19.2** |

8.5 The **Operational Boundary** links directly to the Authority's estimates of the CFR and estimates of other cashflow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely, prudent but not worst case scenario but without the additional headroom included within the Authorised Limit.

8.6 The Treasurer has delegated authority, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long-term liabilities. Decisions will be based on the outcome of financial option appraisals and best value considerations. Any movement between these separate limits will be reported to the next meeting of the Authority.

| **Operational Boundary for External Debt** | **2012/13 Estimate £m** | **2013/14 Estimate £m** | **2014/15 Estimate £m** |
|---|---|---|---|
| Borrowing | 17.9 | 17.1 | 16.5 |
| Other Long-term Liabilities – finance leases | 0.5 | 0.3 | 0.1 |
| **Total** | **18.4** | **17.4** | **16.6** |

## 9 Adoption of the CIPFA Treasury Management Code

9.1 This indicator demonstrates that the Council has adopted the principles of best practice.

| **Adoption of the CIPFA Code of Practice in Treasury Management** |
|---|
| The Council approved the adoption of the CIPFA Treasury Management Code at its meeting on 18 February 2010. |

The Authority has incorporated the changes from the revised CIPFA Code of Practice into its treasury policies, procedures and practices.

## 10 Gross and Net Debt

10.1 The purpose of this treasury indicator is to highlight a situation where the Authority is planning to borrow in advance of need.

| **Gross and Net Debt** | **31/03/2013 Authorised £m** | **31/03/2014 Authorised £m** | **31/03/2015 Authorised £m** |
|---|---|---|---|
| Outstanding Borrowing (at nominal value) | 8.350 | 8.350 | 8.350 |
| Other Long-term Liabilities – finance leases (at nominal value) | 0.521 | 0.252 | 0.066 |
| **Gross Debt** | **8.871** | **8.602** | **8.416** |
| **Less: Investments** | **13.731** | **10.314** | **6.695** |
| **Net Debt** | **(4.860)** | **(1.712)** | **1.721** |

*N.B. CIPFA has acknowledged that this indicator does not work as was intended and is working on a revised one. This indicator will be amended once revised guidance has been received from CIPFA.*

## 11 Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

11.1 These indicators allow the Authority to manage the extent to which it is exposed to changes in interest rates. The upper limits for both fixed and variable rate exposure are based on the Operational Boundary and have been set to give the Authority maximum policy flexibility.

| | 2012/13 Estimate £m | 2013/14 Estimate £m | 2014/15 Estimate £m |
|---|---|---|---|
| **Upper Limit for Fixed Interest Rate Exposure** | 18.4 | 17.4 | 16.6 |
| **Upper Limit for Variable Interest Rate Exposure** | 18.4 | 17.4 | 16.6 |

## 12 Maturity Structure of Fixed Rate Borrowing

12.1 This indicator highlights the existence of any large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates and is designed to protect against excessive exposures to interest rate changes in any one period and, in particular, during the course of the next ten years.

12.2 It is calculated as the amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate. The maturity of borrowing is determined by reference to the earliest date on which the lender can require payment.

| Maturity structure of fixed rate borrowing | Existing level (or Benchmark level) at 31/03/11 % | Lower Limit for 2012/13 % | Upper Limit for 2012/13 % |
|---|---|---|---|
| under 12 months | 0 | 0 | 50 |
| 12 months and within 24 months | 0 | 0 | 50 |
| 24 months and within 5 years | 0 | 0 | 50 |
| 5 years and within 10 years | 15 | 0 | 75 |
| 10 years and within 20 years | 24 | 0 | 75 |
| 20 years and within 30 years | 61 | 0 | 75 |
| 30 years and within 40 years | 0 | 0 | 100 |
| 40 years and within 50 years | 0 | 0 | 100 |
| 50 years and above | 0 | 0 | 100 |

## 13 Credit Risk

13.1 The Authority considers security, liquidity and yield, in that order, when making investment decisions.

13.2 Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the Authority's assessment of counterparty credit risk.

13.3 The Authority also considers alternative assessments of credit strength, and information on corporate developments of and market sentiment towards counterparties. The following key tools are used to assess credit risk:

- published credit ratings for financial institutions (minimum long term rating of A- or equivalent for UK counterparties; AA+ or equivalent for non-UK sovereigns)
- sovereign support mechanisms
- credit default swaps (where quoted)
- share prices (where available)
- economic fundamentals, such as a country's net debt as a percentage of its GDP
- corporate developments, news, articles, market sentiment and momentum
- subjective overlay – or, put more simply, common sense.

13.4 Credit ratings continue to be the only indicator with prescriptive values. Other indicators of creditworthiness are considered in relative rather than absolute terms.

## 14 Upper Limit for Total Principal Sums Invested over 364 Days

14.1 The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Authority having to seek early repayment of the sums invested.

| **Upper Limit for Total Principal Sums Invested over 364 Days** | **2012/13 Estimate £m** | **2013/14 Estimate £m** | **2014/15 Estimate £m** |
|---|---|---|---|
| | **2.0** | **2.0** | **2.0** |

## Economic & Interest Rate Forecast

| | Mar-12 | Jun-12 | Sep-12 | Dec-12 | Mar-13 | Jun-13 | Sep-13 | Dec-13 | Mar-14 | Jun-14 | Sep-14 | Dec-14 | Mar-15 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Official Bank Rate | | | | | | | | | | | | | |
| Upside risk | | | | | 0.25 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| Central case | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| Downside risk | | | | | | | | | | | | | |
| 1-yr LIBID | | | | | | | | | | | | | |
| Upside risk | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| Central case | 1.75 | 1.75 | 1.75 | 1.75 | 1.80 | 1.85 | 1.95 | 2.00 | 2.10 | 2.20 | 2.30 | 2.40 | 2.40 |
| Downside risk | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 |
| 5-yr gilt | | | | | | | | | | | | | |
| Upside risk | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| Central case | 1.30 | 1.35 | 1.40 | 1.50 | 1.60 | 1.70 | 1.80 | 2.00 | 2.10 | 2.30 | 2.40 | 2.50 | 2.50 |
| Downside risk | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 |
| 10-yr gilt | | | | | | | | | | | | | |
| Upside risk | 0.25 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| Central case | 2.30 | 2.40 | 2.45 | 2.50 | 2.55 | 2.60 | 2.70 | 2.75 | 2.80 | 2.85 | 2.90 | 3.00 | 3.00 |
| Downside risk | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 |
| 20-yr gilt | | | | | | | | | | | | | |
| Upside risk | 0.25 | 0.25 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| Central case | 3.05 | 3.05 | 3.10 | 3.20 | 3.25 | 3.30 | 3.35 | 3.40 | 3.45 | 3.50 | 3.60 | 3.75 | 3.75 |
| Downside risk | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 |
| 50-yr gilt | | | | | | | | | | | | | |
| Upside risk | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| Central case | 3.40 | 3.50 | 3.60 | 3.70 | 3.80 | 3.90 | 4.00 | 4.00 | 4.00 | 4.10 | 4.20 | 4.25 | 4.25 |
| Downside risk | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 | -0.25 |

- The UK's status as a safe haven remains for now and keeps Gilt yields suppressed.
- Conventional monetary policy has become largely redundant; the Bank of England and the US Federal Reserve have signalled their respective official interest rates will be on hold through to the end of 2012. It could be 2016 before official interest rates rise.
- The Bank of England's Monetary Policy Committee has returned to unconventional monetary policy and embarked on a further round of Quantitative Easing (QE). There is likely to be more to come.

## Underlying Assumptions:

- Stress in financial markets has continued to build. Rates within Interbank markets (where banks fund the majority of their day-to-day operations) continue to climb. This dynamic was a feature of the banking crisis that occurred in 2008 and, whilst the authorities have flooded the markets with liquidity, still provides a key barometer of rising risk within markets.

- The MPC's decision to embark on a further £75bn of QE – which the Minutes showed was unanimously supported – is likely to be expanded in the coming months as some members of the MPC had voted for £100bn of QE.
- Inflation moderated back to 4.8% in November 2011 from what is considered to be its peak of 5.2% reached in September 2011. The Bank of England expects domestic inflation to subside markedly in 2012 as the twin effects of the VAT increase and surge in oil prices fall out of the twelve month series.
- Economic growth meanwhile remains largely illusive, not helped by the considerable uncertainty and expansion of risks presented by the crisis in the Eurozone. Even if a credible and effective policy is implemented, the scale of the problem means that there is likely to be a prolonged period of subdued growth within the euro area. A failure to meet the challenges would almost certainly have significant implications for the global economy.
- Recent data and surveys suggest that the UK economy has lost the admittedly fragile momentum since the summer. Business and consumer surveys point to continued weakness in coming months and the situation in the euro area is likely to further undermine confidence and lead to tighter credit conditions for households and firms.
- Against this uncertain backdrop the ability of the economy (Government, companies and individual consumers) to accommodate an increase in the cost of money through higher interest rates – in the absence of a deterioration in the high credit standing that the UK enjoys – remains unlikely.

Annex D

## Recommended Sovereign and Counterparty List

| Country/ Domicile | Counterparty | Maximum Counterparty Limit £m |
|---|---|---|
| UK | NatWest | 2 |
| UK | Lloyds TSB | 2 |
| UK | Barclays | 2 |
| UK | HSBC | 2 |
| UK | Nationwide Building Society | 2 |
| UK | Santander UK | 2 |
| UK | Standard Chartered | 2 |
| Australia | Australia and NZ Banking Group | 2 |
| Australia | Commonwealth Bank of Australia | 2 |
| Australia | National Australia Bank | 2 |
| Australia | Westpac Banking Corp | 2 |
| Canada | Bank of Montreal | 2 |
| Canada | Bank of Nova Scotia | 2 |
| Canada | Canadian Imperial Bank of Commerce | 2 |
| Canada | Royal Bank of Canada | 2 |
| Canada | Toronto-Dominion Bank | 2 |
| Finland | Nordea Bank Finland | 2 |
| France | BNP Paribas | 2 |
| France | Credit Agricole | 2 |
| France | Société Générale | 2 |

| | | |
|---|---|---|
| Germany | Deutsche Bank AG | 2 |
| Netherlands | ING Bank NV | 2 |
| Netherlands | Rabobank | 2 |
| Netherlands | Bank Nederlandse Gemeenten | 2 |
| Sweden | Svenska Handelsbanken | 2 |
| Switzerland | Credit Suisse | 2 |
| US | JP Morgan | 2 |

*Please note this list could change if, for example, a counterparty/country is upgraded, and meets our other creditworthiness tools. Alternatively, if a counterparty is downgraded, this list may be shortened.*

## Glossary of Treasury Terms

| | |
|---|---|
| Balances and Reserves | Accumulated sums that are maintained either earmarked for specific future costs or commitments or generally held to meet unforeseen or emergency expenditure. |
| Bank Rate | The official interest rate set by the Bank of England's Monetary Policy Committee and what is generally termed at the "base rate". This rate is also referred to as the 'repo rate'. |
| Bond | A certificate of debt issued by a company, government, or other institution. The bond holder receives interest at a rate stated at the time of issue of the bond. The price of a bond may vary during its life. |
| Capital expenditure | Expenditure on the acquisition, creation or enhancement of capital assets. |
| Capital Financing Requirement (CFR) | The Authority's underlying need to borrow for capital purposes representing the cumulative capital expenditure of the Fire Authority that has not been financed. |
| Capital receipts | Money obtained on the sale of a capital asset. |
| Cost of carry | The cost of "carrying" or holding a position. For example, if one takes out borrowing at 4% and invests the money at 1%, there is a cost of carry of 3%. |
| CPI | Consumer Price Index – the UK's main measure of inflation. Pensions are uprated using the CPI index. |
| Credit Rating | Formal opinion by a registered rating agency of a counterparty's future ability to meet its financial liabilities; these are opinions only and not guarantees. |
| Corporate Bonds | Corporate bonds are bonds issued by companies. The term is often used to cover all bonds other than those issued by governments in their own currencies and includes issues by companies, supranational organisations and government agencies. |
| Diversification / diversified exposure | The spreading of investments among different types of assets or between markets in order to reduce risk. |
| ECB | European Central Bank. |
| Federal Reserve | The US central bank. (Often referred to as "the Fed"). |
| General Fund | This includes most of the day-to-day spending and income. |
| Government Gilts | Gilts are bonds issued by the UK Government. They take their name from 'gilt-edged': being issued by the UK Government, they are deemed to be very secure as the investor expects to receive the full face value of the bond to be repaid on maturity. |
| IFRS | International Financial Reporting Standards. |
| Maturity | The date when an investment or borrowing is repaid. |
| Maturity profile | A table or graph showing the amount (or percentage) of debt or investments maturing over a time period. The amount or percent maturing could be shown on a year-by-year or quarter-by-quarter or month-by-month basis. |

| | |
|---|---|
| Money Market Funds (MMF) | Pooled funds which invest in a range of short term assets providing high credit quality and high liquidity. |
| Minimum Revenue Provision | An annual provision that the Authority is statutorily required to set aside and charge to the Revenue Account for the repayment of debt associated with expenditure incurred on capital assets. |
| Non-Specified Investments | Term used in the Communities and Local Government Guidance and Welsh Assembly Guidance for Local Authority Investments. It includes any investment for periods greater than one year or those with bodies that do not have a high credit rating, use of which must be justified. |
| Premiums and Discounts | In the context of the Fire Authority's borrowing, (a) the premium is the penalty arising when a loan is redeemed prior to its maturity date and (b) the discount is the gain arising when a loan is redeemed prior to its maturity date. If on a £1 million loan, it is calculated* that a £100,000 premium is payable on premature redemption, then the amount paid by the borrower to redeem the loan is £1,100,000 plus accrued interest. If on a £1 million loan, it is calculated that a £100,000 discount receivable on premature redemption, then the amount paid by the borrower to redeem the loan is £900,000 plus accrued interest.<br><br>PWLB premium/discount rates are calculated according to the length of time to maturity, current market rates (plus a margin), and the existing loan rate which then produces a premium/discount dependent on whether the discount rate is lower/higher than the coupon rate.<br><br>*The calculation of the total amount payable to redeem a loan borrowed from the Public Works Loans Board (PWLB) is the present value of the remaining payments of principal and interest due in respect of the loan being repaid prematurely, calculated on normal actuarial principles. More details are contained in the PWLB's lending arrangements circular. |
| Prudential Code | Developed by CIPFA and introduced on 1 April 2004 as a professional code of practice to support Fire Authority capital investment planning within a clear, affordable, prudent and sustainable framework and in accordance with good professional practice. |
| Prudential Indicators | Indicators determined by the Fire Authority to define the its capital expenditure and asset management framework. They are designed to support and record local decision making in a manner that is publicly accountable; they are not intended to be comparative performance indicators. |
| PWLB | Public Works Loan Board. It is a statutory body operating within the United Kingdom Debt Management Office, an Executive Agency of HM Treasury. The PWLB's function is to lend money from the National Loans Fund to local authorities and other prescribed bodies, and to collect the repayments. |

| | |
|---|---|
| Quantitative Easing | In relation to the UK, it is the process used by the Bank of England to directly increase the quantity of money in the economy. It "does not involve printing more banknotes. Instead, the Bank buys assets from private sector institutions – that could be insurance companies, pension funds, banks or non-financial firms – and credits the seller's bank account. So the seller has more money in their bank account, while their bank holds a corresponding claim against the Bank of England (known as reserves). The end result is more money out in the wider economy". Source: Bank of England. |
| Revenue expenditure | Expenditure to meet the continuing cost of delivery of services including salaries and wages, the purchase of materials and capital financing charges. |
| RPI | Retail Prices Index. A monthly index demonstrating the movement in the cost of living as it tracks the prices of goods and services including mortgage interest and rent. Index-linked gilts are uprated using the RPI index. |
| Specified Investments | Term used in the Communities and Local Government Guidance and Welsh Assembly Guidance for Local Authority Investments. Investments that offer high security and high liquidity, in sterling and for no more than one year. UK Government, local authorities and bodies that have a high credit rating. |
| Supported Borrowing | Borrowing for which the costs are supported by the Government or third party. |
| Supranational Bonds | Instruments issued by supranational organisations created by governments through international treaties (often called multilateral development banks). The bonds carry a AAA rating in their own right. Examples of supranational organisations are the European Investment Bank, the International Bank for Reconstruction and Development. |
| Treasury Management Code | CIPFA's Code of Practice for Treasury Management in the Public Services. |
| Temporary Borrowing | Borrowing to cover peaks and troughs of cash flow, not to fund spending. |
| Term Deposits | Deposits of cash with terms attached relating to maturity and rate of return (interest). |
| Unsupported Borrowing | Borrowing which is self-financed by the Fire Authority. This is also sometimes referred to as Prudential Borrowing. |
| Yield | The measure of the return on an investment instrument. |