

Treasury Management Strategy for 2009-10

As updated for resolutions of the Police Authority 13 February 2009. Minute reference P2309.

Recommendations:

- That the Treasury Management / Investment Strategy be approved and specifically:**
- (i) the Annual Investment Strategy be approved;**
 - (ii) the Borrowing and Debt Management Strategy be approved;**
 - (iii) that Investec are retained to invest surplus funds on behalf of the Police Authority, subject to satisfactory performance;**
 - (iv) the services of Devon County Council are retained to provide day to day cash management on behalf of the Police Authority;**
 - (v) that the Police Authority continues to operate a Devon and Cornwall Police Investment Fund managed by the Treasurer;**
 - (vi) that the Treasurer should retain the flexibility to invest funds directly and to vary amounts invested with Investec and in the Devon and Cornwall Police Investment Fund within the limits set out in the strategy;**
 - (vii) the Treasurer be authorised to create and maintain a counter-party list consistent with the principles in this strategy and sensitive to publicised changes in the fortunes of individual institutions;**
 - (viii) the use of Barclays as the Authority's bankers be noted.**

Resolutions

All recommendations were approved as set out above with the exception of recommendation (iii). In addition an amendment to the proposed lending list for the current External Fund Manager was agreed. This is reflected in Annex 3 attached. With regard to recommendation (iii), the Police Authority resolved to enter into discussions with the External Managers before confirming their retention.

1 Introduction

- 1.1 The Treasurer is required to present a Treasury Management Strategy to Members each year, setting out how investments, borrowing, cash flows and banking arrangements will operate during the year. In addition, police authorities are required to approve an Annual Investment Strategy before the start of the financial year. As in previous years, this draft document for 2009-10 incorporates both requirements and is now presented to members for their consideration.
- 1.2 This document should be read in conjunction with the Three Year Financial Strategy report elsewhere on this agenda, in particular the pages "Prudential Indicators" applicable to treasury management and borrowing requirements. The Police Authority has adopted the CIPFA Code of Practice for Treasury Management and the Strategy reflects the requirements of the code.

2 Economic Context

- 2.1 The last twelve months has seen a transformation in the economic outlook. A year ago inflation was the main economic concern and the impact was to maintain UK interest rates at a relatively high level. The serious down turn in the economy over the autumn of 2008 has caused a rapid reduction in UK base rates from 5% in September 2008 to 1.5% in January 2009.
- 2.2 Closely linked to the changes in the economy are the problems in the banking sector. These caused a review of the Police Authority investment strategy during 2008-09 that restricted the counter-parties to whom the Authority was prepared to lend. This change has had and will continue to have an impact on investment returns.
- 2.3 The consensus among economic forecasters is that negative growth will persist in 2009. The outlook beyond the end of the calendar year is less clear.

3.0 Prospect for Interest Rates

- 3.1 Forecasting future interest rate movements, even one year ahead, is always difficult. The factors affecting interest rate movements are clearly outside the Authority's control. Whilst short term rates are generally linked to the Bank of England's Base Rate, long term rates are determined by other factors e.g. the market in Gilts.
- 3.2 Base rate forecasts from a number of sources, including the HM Treasury survey of economic forecasts, have been reviewed. These indicate a further 0.5% cut in the base rate to 1.0% by March 2009 and the rates remaining at this level until the end of 2009.
- 3.3 Although base rates are an important indicator, it is the movement in market rates that determines the performance of the Authority's investments. A feature of first nine months of 2008 was the growth in the margin between bank base rates and market rates and this was a reflection of the lack of liquidity in the market. Action taken by the Bank of England to inject cash into the economy resulted in the margin declining steadily from November 2008 onwards. It is difficult to predict how much more the gap between the base rates and the market rates will close.
- 3.4 On the basis of the base rate and market rate forecasts available, the following rates have been assumed for new lending and borrowing in 2009/10.

	April 2009	Sept 2009
<u>Lending Rates</u>	%	%
Base Rate	1.0	1.0
12 Month LIBID (market rate)	1.5	1.0
<u>Borrowing Rate</u>		
Public Works Loan Board	3.0	3.0

4.0 Investment Strategy 2009-10 to 2011-12

4.1 Subject to a balanced budget, the Authority has sufficient cash available to meet short-term and operational requirements in the coming year. Prudent financial management has allowed the Authority to build up general balances, earmarked reserves and provisions. Within the Three Year Financial Strategy, reserves are progressively reduced. In 2009-10 the reduction is approximately £7m. As described in section 5 below, the timing of borrowing to fund capital expenditure already incurred in 2008-9 and forecast expenditure in 2009-10 is uncertain. This will have an impact on the sums available to invest

4.2 The Police Authority has three different mechanisms for investing surplus funds:

- Sterling investments managed by Investec, the Authority's external fund managers (forecast balance as at 31 March 2009 - £21 million);
- Devon and Cornwall Police Investment Fund managed by the Treasurer (forecast balance as at 31 March 2009 £15.5 million). This fund is invested solely in fixed interest deposits. The remit of the fund is contained at Annex 1;
- Very short term deposits varying from overnight to 3 months - managed by Devon County Council

4.3 Throughout 2008-09, the long term forecast was for interest rates to fall. In managing investments (in particular investments in the Devon and Cornwall Investment Fund) the strategy has been to lend for relatively long periods (365 days or more). The Treasury Management Strategy places prudent limits on this approach to ensure the security of investments and maintain adequate levels of liquidity. Nevertheless it has been possible to fix a large portion of the fund at what has now proved to be very favourable interest rates. The budgeted level of returns for the authority's investment in 2009-10 are given in the table below.

	Forecast Investments 31/03/2009	Forecast Average Rate for 2009-10
	£m	%
Funds managed by Investec	21.0	2.0
Devon and Cornwall Police Investment Fund	15.5	3.9
Short Term Deposits	7.4	1.0

Investec have provided forecasts in the range of 2.0% - 3.0%.

4.4 The Police Authority has a prudent approach to investments and it is pleasing to note that no losses have been incurred as a result of the recent problems in the banking sector. Changes to the investment strategy were made during 2008-09 and these are reflected in the detailed Investment Strategy Principles outlined below. These arrangements will remain in place for the foreseeable future but may need to be revised either to further restrict the lending lists or to ease the restrictions depending on changes in the financial environment.

- 4.5 It should be borne in mind that it would be impossible for the Authority to mitigate against all of the possible risks inherent in investing cash balances. Further economic or banking problems could impact on the security or returns achieved from the investment strategy.

Foreign Currencies

- 4.6 In exceptional circumstances, the Treasurer will be empowered to invest in foreign currencies but only with the explicit approval of the Resources Committee or the Urgency Committee.

Investment Strategy Principles

- 4.7 Guidance under section 15 (1) (a) of the Local Government Act requires the Authority to establish an Annual Investment Strategy. This part of the Treasury Management Strategy sets out how this guidance is complied with.

- 4.8 Prudence

The Authority will at all times invest its surplus funds prudently. Priority will be given to security and liquidity rather than yield. However, the highest available rate of interest consistent with proper levels of security and liquidity will always be sought.

- 4.9 Specified Investments

Specified Investments are those usually offering high security and high liquidity. All such investments should be in sterling with a maturity of no more than one year. They include investments with the UK Government, UK Local Authorities and with banks, building societies or at times money market funds that have high credit ratings. Available funds may be invested in specified investments without reference to any limits set by the government.

- 4.10 Non-Specified Investments

These are defined as any investments that do not meet the definition of specified investments. The Strategy must identify the types of Non-Specified Investments that may be used during the year, set maximum limits and lay down guidelines for making decisions. Different limits and controls will be applied to the three different types of investment described in paragraph 4.2 above.

External Fund Manager

- 4.11 Investec will use counter-parties rated AA- or above. Although this is the minimum, investment will generally be with higher rated counter-parties. The Credit rating agency used is Fitch IBCA.

- 4.12 All investments will be specified investments with the following exception:

Non-specified investments up to a limit of 30% of their overall portfolio may be used. These must be in UK government bonds with maturity

period above one year and/or certificates of deposit with maturity periods between one year and two years and/or supranational bonds. The Treasurer has advised the manager that any trades in supranational bonds must be discussed with him in advance.

- 4.13 The maximum average duration for the portfolio held by the investment manager will be 5 years. The maximum percentage of the portfolio, which the fund manager can invest with any one institution, is 15%.
- 4.14 Over the recent period of uncertainty with regard to the security of investments the Treasurer has given Investec specific instructions with regard to the management of the lending list for the Police Authority funds. This has limited investment with foreign banks. The current lending list is attached as Annex 3.

Devon and Cornwall Police Investment Fund

- 4.15 The investment strategy for the Devon and Cornwall Police Investment Fund is set out in Annex 1. The credit ratings applied to the Devon and Cornwall Police Investment Fund will be those provided by the Fitch IBCA credit ratings agency. Credit ratings are monitored monthly but downgrades or potential downgrades that are reported between reviews will be acted upon. Even Institutions with a high credit rating will be avoided if there is a valid reason to do so.
- 4.16 The counter-party list is constructed according to the following principles:

<u>Counter-party Type</u>	<u>Short Term Rating</u>	<u>Long Term Rating *</u>	<u>Credit Limit</u>
UK banks rated F1	F1	AA and above	£3 million
Building Societies, Assets greater than £50 billion **	N/A	N/A	£3 million
Building Societies, Assets less than £50 billion but over £1.0 billion **	N/A	N/A	£1 million
Foreign banks (excluding banks based in the Republic of Ireland)	F1+	AA and above	Currently suspended from the list
Banks based in the Republic of Ireland	F1+	AA and above	Currently suspended from the list
Larger Local Authorities	N/A	N/A	£3 million
Smaller local Authorities	N/A	N/A	£1 million
Debt Management Account (central government)	N/A	N/A	£25 million
Money Market Funds	AAA	AAA	Currently suspended from the list

*Credit ratings can be graded AAA-, AAA and AAA+ and similarly for AA and A. All institutions within the cohort AAA, AA or A will be included on the counter-party list as indicated.

** Building societies are graded on the list according to their level of assets. Some building societies do have credit ratings. For those that have credit ratings they will only be included on the list if their credit rating is A or above.

Individual institutions may be suspended from the list should that be deemed appropriate.

Foreign banks rated F1 and below and US banks are excluded from the list.

4.17 The full counter-party list is attached as Annex 2. The Treasurer has delegated authority to make changes to the list to respond to individual events. These will be reported retrospectively to the Resources Committee.

4.18 All investments will be specified investments with the following exception:

Non-specified investments up to a limit of the lesser of £10m or 50% of the overall portfolio may be used. These must be fixed interest deposits with UK and Overseas banks, UK Building Societies, the Debt Management Deposit Facility, Local Authorities or pooled money market funds for more than 364 days.

Daily Cash

4.19 This is managed on the Authority's behalf by Devon County Council. Performance has been excellent and continuation of this arrangement is recommended.

4.20 The counter-party list that is used for the Devon and Cornwall Police Investment Fund will be used for daily cash deposits. It will be operated in such a way that Investment Fund deposits and daily cash deposits, when added together, will not exceed the limit for any given counter-party.

4.21 All daily cash deposits will be specified investments.

Performance

4.22 The benchmark for performance for the external fund manager and the Investment fund will be the 7 day LIBID (London Interbank Rate)

5 Capital Spending and Long Term Borrowing

5.1 The Authority has adopted the CIPFA Prudential Code for Capital Finance in Local Authorities and all borrowing is within the Code's Prudential Indicators detailed in the Three Year Financial Strategy report.

5.2 Because interest rates have not been favourable, no new borrowing has taken place in 2008-09. Furthermore it may be appropriate to delay borrowing beyond the year end. If no borrowing takes place in 2008-09, the Police Authority will draw on revenue resources to temporarily fund capital expenditure. This would be made good when the PWLB rates fall sufficiently.

- 5.3 The Police Authority's strategy in previous years has been to borrow at fixed rates over periods that reflect the estimated life of the asset. There is no regulatory requirement to do this. The Prudential Code recommends that Authority's avoid large concentrations of fixed rate debt that has the same maturity structure. The structure of current debt is such that all of the loans mature over an eight year period from May 2029.
- 5.4 Forecast of rates of interest that will apply to borrowing suggest that debt with maturity periods of 20 years or more may exceed the Authority's target rate of 3.0%. For this reason and also to achieve a more even spread of maturities, the Authority may borrow for shorter periods depending on the rates available at the time.
- 5.5 It should be recognised, however, that borrowing for a short period or having a large amount of borrowing maturing at one time increases the risk of being forced to borrow when rates are high. To avoid this, careful consideration will be given to the maturity structure of any new borrowing. All borrowing will be within the limits set out in the prudential indicators report.
- 5.6 If borrowing rates do not reach what are considered favourable levels (given the economic outlook and the rates available on investments) it may be necessary for the Authority to temporarily fund capital expenditure from its own cash balances.
- 5.7 The Three Year Financial Strategy elsewhere on this agenda details borrowing to fund the proposed capital programme. The programme assumes some borrowing for shorter life assets – the replacement of the helicopter and Project Mercury (the project to replace the Operational Intelligence System/Crime Intelligence System). These assets have a forecast life of 10 years and revenue provision will need to be set aside to repay the debt over this period. If Members approve the Three Year Financial Strategy, actual borrowing would be drawn down during the year with due regard to current interest rates, progress on spending and the criteria outlined above.

6 Cash Flow

- 6.1 Cash flow within the Three Year Financial Strategy covers the three years to 2011-12. A cashflow model has been used to forecast cash movements. The range of investments held by the Police Authority will be managed to ensure that sufficient funds are available to meet daily cash flow needs.

7 Monitoring

- 7.1 Income and expenditure will be monitored monthly to ascertain performance against the budget.

- 7.2 Performance and changes in borrowing, management and lending are all reported regularly to members of the Resources Committee. Police Authority members meet with external managers periodically to assess progress. The last meeting was in December 2008.

8 Banking Arrangements

- 8.1 The Authority's bankers are Barclays PLC. The current contract for banking services expires on 31 March 2011.

9 Conclusion

- 9.1 The outlook for 2009-10 is very different from that which prevailed 12 months ago. The turmoil in the banking sector and the related downturn in the economy have had a significant impact on the Treasury Management Strategy. Changes have been made to the Authority's lending lists to strengthen the security of investments. The fall in interest rates, arising from the economic slow-down, has meant a reduction of over £900,000 in the budget for interest received. Close monitoring of the strategy will take place during the year to ensure that risks are properly managed and returns maximised. The Treasurer will decide on appropriate long-term borrowing levels to meet the budget approved by members in the light of prevailing and forecast interest rates.

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Devon and Cornwall Police Investment Fund

Purpose

To invest cash balances to achieve best value in terms of return whilst giving primacy to the effective management and control of risk. This means that the security of the principal sums invested and the liquidity of funds will be given priority over yield.

Investment Strategy

- 1 Investments will be limited to fixed interest deposits with UK and Overseas banks and UK building societies, the Debt Management Account Deposit Facility provided by central government and pooled money market funds. Other than in exceptional circumstances the focus will be on investments for 28 days or over.
- 2 Funds to be invested only with counter-parties on the approved list.
- 3 The fund will not invest directly in government bonds, certificates of deposit, foreign currency or international bonds.
- 4 Investments for more than one year are classified as non-specified investments. A limit of 50% of the overall portfolio will be placed on the amount of the fund that can be invested for a period of more than 1 year.
- 5 The benchmark for performance will be the 7 day LIBID (London Inter Bank Bid Rate).
- 6 Investment decisions within the policy will be taken by the Treasurer after advice from officers of Devon County Council and Devon and Cornwall Police

Annex 2

Devon and Cornwall Police Approved List of Borrowers		Counter-party	Group Limit
As at 13 February 2009		£ millions	£ millions
UK Clearing Banks & Subsidiaries			
Barclays Bank		3	
HSBC Bank		3	
Lloyds TSB Bank		3 }	
HBOS Bank of Scotland		3 }	3
HBOS Bank of Scotland (Ireland)		3 }	
Northern Rock (maximum maturity 3 months)		3	
Royal Bank of Scotland		3 }	
Ulster Bank		3 }	3
Ulster Bank Ireland		3 }	
Building Societies			
Nationwide		3 }	
Cheshire (No further new deposits)		3 }	3
Derbyshire (No further new deposits)		3 }	
Britannia		1	
Chelsea		1	
Coventry		1	
Cumberland		1	
Dunfermline		1	
Kent Reliance		1	
Leeds		1	
National Counties		1	
Newcastle		1	
Norwich & Peterborough		1	
Nottingham		1	
Principality		1	
Progressive		1	
Skipton		1 }	1
Scarborough		1 }	
Stroud & Swindon		1	
West Bromwich		1	
Yorkshire		1	
Local Authorities			
County Councils		3	
Metropolitan Authorities		3	
London Boroughs		3	
English Unitaries		3	
Scottish Unitaries		3	
District Councils		1	
Welsh Unitaries		1	
Other Authorities (Eg. Police, Fire, Etc.)		1	
Overseas Banks (& subsidiaries operating in London)			
Allied Irish Bank		Suspended	
Bank of Ireland		Suspended	
Debt Management Office (central Government)			
DMA Deposit Facility (DMADF)		25	

Lending List for External Fund Manager

As at 13 February 2009

Counter-party	Country	Limit
United Kingdom		
UK Government Bonds	UK	No limit on short dated bonds, bonds of over 364 days constrained by 30% limit on non-specified investments
Deposits with the Management Office	Debt UK	No limit
<u>Banks</u>		
Abbey National	UK)15% of Investec Fund
Alliance & Leicester	UK)
Barclays	UK	15% of Investec Fund
HSBC	UK	15% of Investec Fund
Lloyds TSB	UK	15% of Investec Fund
Royal Bank of Scotland	UK	15% of Investec Fund
<u>Building Societies</u>		
Nationwide	UK	15% of Investec Fund
Overseas Institutions		
National Bank of Australia	Australia	15% of Investec Fund
BNP Paribas	France	15% of Investec Fund
Credit Agricole Group	France	15% of Investec Fund
Society General	France	15% of Investec Fund
Deutsche Bank	Germany	15% of Investec Fund
ING	Netherlands	15% of Investec Fund
Rabobank	Netherlands	15% of Investec Fund

Investec the external fund manager may also invest in supranational bonds and in other overseas institutions after specific agreement by the Police Authority Treasurer.