

APPENDIX B**TREASURY MANAGEMENT STRATEGY, ANNUAL INVESTMENT STRATEGY AND BORROWING LIMITS****SUMMARY**

This Appendix addresses the requirements of the prudential code and sets out borrowing and investment strategies and a policy statement on the minimum revenue provision required to be set aside to repay debt.

1. BACKGROUND

- 1.1 The Local Government Act 2003 and supporting regulations require the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.
- 1.2 Accordingly this report sets out a proposed treasury strategy for borrowing and an investment strategy which sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.
- 1.3 The suggested strategy for 2009/10 to 2011/12 in respect of the following aspects of the treasury management function is based upon the Treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor. The strategy covers:
 - treasury limits and prudential indicators;
 - The current treasury position;
 - prospects for interest rates;
 - the borrowing strategy including ALMO borrowing;
 - the investment strategy;
 - a minimum revenue provision policy statement - this new requirement is explained in 3.1
- 1.4 It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore, means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from:
 - increases in interest charges caused by increased borrowing to finance additional capital expenditure, and
 - any increases in running costs from new capital projectsare limited to a level which is affordable within the projected income of the Council for the foreseeable future.

2. TREASURY LIMITS AND PRUDENTIAL INDICATORS FOR 2009/10 TO 2011/12

- 2.1 It is a statutory duty under S.3 of the Local Government Act 2003 and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the “Affordable Borrowing Limit”. In England and Wales the Authorised Limit represents the legislative limit specified in section 3 of the Local Government Act 2003.
- 2.2 The Council must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax and council rent levels is ‘acceptable’.
- 2.3 Whilst termed an “Affordable Borrowing Limit”, the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.
- 2.4 It is also a requirement of the Prudential Code for the authority to set an operational boundary. This represents our most likely estimate of external debt rather than the outer boundary set by the Authorised Limit and is intended to inform daily treasury management activity.
- 2.5 The prudential indicators which are relevant for the purposes of setting an integrated treasury management strategy and which require Committee approval are set out in Annexes TM1 and TM2. TM1 sets out prudential indicators to support the Council’s capital financing borrowing requirement. Annex TM2 sets out treasury management borrowing limits and prudential indicators.

3. MINIMUM REVENUE PROVISION POLICY STATEMENT

- 3.1 Where capital expenditure has been incurred through the use of borrowing approvals, the Council is required to set aside an amount from revenue each year to provide for the eventual repayment of this expenditure. The Government issued new guidance in February 2008 for the way Councils make repayments of debt and the Council is required to include in its Treasury Management Strategy a policy statement on how the government guidance will be implemented. This is set out in Appendix TM5.

4. CURRENT TREASURY POSITION AND REVIEW OF ACTIVITIES DURING 2008/09

Long-term borrowing

- 4.1 The Public Works Loan Board (PWLB) is the main source of local authority long term loans. For Sutton, out of total long term borrowing of £65.28m at 1 April 2008, some £49.98m was with the PWLB whilst £15.3m is with banks. During 2008/09, as outlined in the remainder of this Section, such borrowing is expected to reduce slightly with small natural maturities of debt. Our expected long term borrowing requirement for 2008/09 as set out in the Treasury Management Strategy, Annual Investment Strategy and Borrowing Limits Report 2007/08 was £70.8m.
- 4.2 No new long term borrowing has been undertaken so far this year as internal balances are being used initially rather than external borrowing. Temporary

borrowing will cover any cash flow shortfalls and I expect the Council's debt to be £65.09 at the end of 2008/09. This compares with external debt of £65.28m at 31 March 2008. The average annual borrowing rate on our long term debt is 5.00%. A graph showing the maturity profile of our long term debt as at 31 March 2009 is attached at TM3.

- 4.3 As part of their contract with the Council, Sector, our Treasury Management advisors, keep the Council's loan portfolio under review to see if savings can be made by further debt restructuring. No restructuring has been undertaken in 2008/09 as market conditions have not been favourable.

Temporary Borrowing

- 4.4 Council approved a temporary borrowing limit of £15.8m for 2008/09. During the first half of the year, the Council has raised 4 temporary loans from periods ranging from overnight to 5 days. For the rest of 2008/2009, it may be necessary to undertake some further temporary borrowing.

Investments

- 4.5 Investments totalled £40.35m at the beginning of the year. During 2008/09, individual investment transactions have been averaging £2.3m lent for periods from overnight to 2 years. Interest earned to the end of December on short term investments was £2.9m and is forecast to be approximately £3.8m for the financial year. This reflects significantly higher interest rates than anticipated (see Section 4) and also larger balances available for investment due in part to unspent grant money in respect of the Stanley Park High School Project. As a result anticipated interest earnings for the year will exceed original estimates by £1.0m on General Fund balances and £0.8m on other reserves, balances and ring-fenced accounts. The average interest rate earned by the London Borough of Sutton to the end of December was 5.26%, which is higher than our benchmark return 4.93%. The benchmark is the average of the 7 day and 3 month LIBID figure (LIBID stands for the London Interbank Bid Rate).

The Banking Crisis

- 4.6 The sub prime crisis of early 2008 was supplanted by the banking crisis of autumn 2008. The world banking system came near to collapse and governments around the world were forced to recapitalise and rescue their major banks. The resulting dearth of lending from banks anxious to preserve capital led to economic forecasts being sharply reduced and recession priced into markets. This in turn led to sharp falls in oil and other commodity prices and rapid falls in inflation and economic demand and activity. As part of the international financial crisis Icelandic banks were nationalised and went into receivership in early October.

Heritable Bank

- 4.7 At the time, the Council had £5.5m on deposit with Heritable Bank, a UK subsidiary of Landsbanki, an Icelandic bank. On 7th October 2008 Heritable Bank was put into administration by the High Court in London following the nationalisation of Landsbanki by the Icelandic Government. The assets held by Heritable bank are currently frozen which includes the deposits made by the Council.
- 4.8 An independent investigation was undertaken and reported to the Audit Committee on 24 October 2008. This review concluded that the Council's operating framework for treasury management was comparable with best practice in the sector and the deposits with Heritable Bank had been executed entirely in accordance with that

framework as approved by the Council. A number of recommendations as to future policies were made which have been subsequently implemented.

- 4.9 Ernest & Young have been appointed as the administrators for Heritable Bank. The Council formally lodged its claim as a creditor with Ernest & Young on 10 November. The claim is for the £5.5m investment, plus the agreed level of interest due on those investments up to maturity and an additional claim for investment income lost from the dates the deposits were due to mature.
- 4.10 At this stage Ernst and Young will only say that they 'consider that there will be a material dividend payable in due course for unsecured creditors. However because of the significant uncertainties discussed above, it is too early to provide a realistic estimate as to quantum or timing at this time.'

Impact on Investment Strategy

- 4.11 The Council's Investment Strategy for investment of surplus funds is agreed annually by the Council as part of the budget report. Immediately following the failure of the Icelandic banks, the Council had been placing deposits with a more restricted list of counterparties within the overall agreed policy. This list of Counterparties included the eight UK banks and Building Societies that have access to the Government's rescue package and Irish Banks guaranteed by the Irish Government.
- 4.12 This measure was a short term response to the uncertainty surrounding the banking system and it was recognised that lending criteria would require further review as outlined in the recommendations arising from the independent external review.
- 4.13 On 13 November officers met with the Managing Director of Sector, the Council's treasury advisors, to review the current investment strategy and develop a proposed new counterparty list. It was recognised that any changes to the counterparty list would require a balance to be struck between tightening criteria to limit risk and ensuring that the Council has sufficient counterparties to place deposits with. It would also need to be clear and coherent for ease and consistency of operation.
- 4.14 The revised criteria developed from this meeting introduced the use of a sovereign rating to assess the ability of countries to provide financial support to their banks. They also tightened the minimum individual bank ratings for institutions that the Council can invest with. The revised criteria were agreed by the Executive and the Audit Committee in December 2008 for use within the existing policy during the period to 31 March 2009. The Audit Committee also proposed, and the Executive agreed, that the Council should only place funds with banks that are rated by more than one rating agency. These recommendations also form the basis of the investment strategy set out in Section 7 and recommended for adoption for 2009/10.

5. PROSPECTS FOR INTEREST RATES

- 5.1 The bank rate at the start of 2008/09 was 5.25% and it was decreased to 5.00% in April, 4.50% in October, 3.00% in November and 2% in December. There were further reductions in 2009 to 1.5% in January and 1% in February, the lowest rate in the Bank's 315 year history. The 'average' City view is that bank rate will fall further in 2009/10 ending the financial year at 0.50%.
- 5.2 A feature of the year has been that because of the lack of liquidity in the banking sector, actual interest rates have been substantially higher than the bank rate and only since November has the power of the Government over semi-nationalised

clearing banks had considerable impact in enforcing reductions in some borrowing rates in line with base rate reductions.

- 5.3 PWLB rates started 2008/09 at 4.43 % for over 50 years maturity loans and fluctuated during the course of the year with a low of 3.86% and a high of 4.82%. The view of our Treasury Management advisors is that the 50 year PWLB rates will remain flat at around 3.80% in 2009 and the 25 year PWLB rates at around 3.95%.

6. BORROWING STRATEGY 2009/10 - 2011/12

General

- 6.1 Within the prudent framework set out above we will monitor interest rate movements and adopt a balanced and pragmatic approach to any changing circumstances. The Council will continue its policy of maintaining a planned and stable maturity pattern for its loans whilst borrowing as cheaply as possible using all available prudent money market instruments.
- 6.2 There are no natural maturities of existing loan debt due in the next 3 years. There are small scale repayments of principle due on annuity loans in each year of around £0.2k. Therefore there will be no need to undertake any significant replacement borrowing other than for debt restructuring.
- 6.3 The Operational boundary we have set of £77.0m in 2009/10 suggests we may need new borrowing of up to £1.3m. The operational boundary in 2010/11 is £79.1m and £79.2m in 2011/12 with implied new borrowing of up to £2.1m and £0.1m respectively. The timing and extent of new borrowing will depend on internal cash balances available and market rates.
- 6.4 Long term funding need has traditionally been met from the PWLB unless market loans were significantly cheaper. The changed arrangements for loan redemptions have reduced the flexibility of PWLB loans and made them relatively less attractive, so the position of PWLB as lender of first resort will need to be kept under review.
- 6.5 Sector's advice is that the cheapest PWLB borrowing will be variable rate borrowing instead of long term fixed rate borrowing. Under 10 year PWLB loans are expected to drop to 2.55% in the middle of 2009 before rising to 4.85% at the end of the financial year. Under 5 year loans are expected to fall to 2.15% before rising to 4.85% at the end of the financial year.
- 6.6 We will monitor the market through the year taking account of relative movements in interest rates over the different maturity periods, spreads between PWLB new borrowing and early payment rates and any further changes that the PWLB may introduce. Consideration will be given to undertaking new fixed long term PWLB borrowing when rates fall to a target rate of 3.95% or lower. We will also give consideration to borrowing fixed rate market loans at between 3.45% and 3.70% if they become available again.
- 6.7 In consultation with our Treasury Management Consultants, the Council will continue to look for opportunities to reduce the cost of our outstanding debt through debt restructuring provided it is risk averse and accords with the guidelines set out above.
- 6.8 Currently the Council's actual long term borrowing is well below its capital financing limit. This difference represents the extent to which the Council is financing capital investment from internal cash balances. This is a consequence of our treasury

management strategy which manages the Council's cashflows in an integrated way so that external borrowing arises as a consequence of all the financial transactions of the Council and not simply those arising from capital spending. This approach has served the Council well and kept levels of debt (and cash balances available for investment) to a minimum. The next financial year is expected to be a time of historically abnormally low Bank Rate so the policy of internally borrowing money rather than undertaking new external borrowing will continue. This also has benefits of reducing exposure to interest rate and credit risk. If financial conditions are advantageous internal borrowing may also be increased through early repayment of debt as set out in paragraph 7.8 below. It may be appropriate to review this policy as part of the overall management of our borrowing requirements in order to give greater flexibility to secure borrowing when market conditions are financially advantageous. This could also help to ensure cost effective management of ALMO borrowing requirements (see next section).

ALMO Borrowing Requirements

- 6.9 The Council has delegated its housing management functions to an Arms Length Management Organisation (Sutton Housing Partnership). The Council's bid for Decent Homes Funding to improve the housing stock has been awarded £112m under Tranche 6 of the ALMO funding arrangements. Receipt of funding is subject to the ALMO achieving a two star rating at inspection, which is due in October 2009 with the final outcome likely to be known in early 2010.
- 6.10 The financial arrangements are that on final approval of the funding the Council would undertake all the borrowing necessary to finance this housing capital expenditure. The Government would provide revenue support for the cost of the borrowing through the Housing Revenue Account Subsidy (HRAS) system.
- 6.11 The necessary borrowing would be undertaken as part of our overall treasury management arrangements. Close liaison would be maintained with the ALMO who would need to supply regular cash flow forecasts so that, as far as practicable, borrowing can be undertaken when market conditions are at their most favourable.
- 6.12 No allowance for ALMO borrowing has currently been made in our treasury management borrowing limits and prudential indicators as it is still subject to approval. However it would clearly have a major impact on our future treasury management operations and will need careful planning as the release of funds approaches.

7. ANNUAL INVESTMENT STRATEGY 2009/10

- 7.1 Within the overall Treasury Management Strategy, the Local Government Act 2003 requires the Council to produce an Annual Investment Strategy before the start of each financial year, which it may vary at any time. The Strategy and any variations are to be approved by full Council and are to be made available to the public. The paragraphs below set out the Council's Strategy for 2009/10.
- 7.2 The Council will invest its surplus funds prudently with priority to be given to security and liquidity rather than yield. It will seek the highest rate of interest consistent with the proper levels of security and liquidity.
- 7.3 The Council will have regard to the ability of countries to provide financial support to their banks and will only invest in institutions domiciled in countries with a Sovereign rating of AA+ or higher. To minimise risk it is proposed that the minimum individual

bank ratings for institutions that the Council can invest with are also tightened to a minimum rating of AA- (from A prior to October 2008).

7.4 The following set of criteria are proposed:

- Institutions domiciled in AAA to AA+ Sovereign rated Countries
- UK Guaranteed Institutions including Northern Rock and Bradford and Bingley
- Individual institutions within the above restrictions that are rated by both Fitch and Moody with a minimum at:
 - Fitch - AA- (long term) and F1+ (short term), C individual rating and 2 support rating
 - Moody - Aa3 (long term) and P-1 (short term) and C- (individual)
- Money Market Funds Rated MR1+

The individual investment limits and maximum investment periods for counterparties are assessed on the basis of Sector's credit ratings and recommendations to ensure an appropriate spread of credit risk. Limits proposed at the current time are linked to the Sector colour matrices and are as follows:

- Red - £7.5m, up to 3 months
- Orange - £12.5m, up to 1 year
- Purple - £15.0m, up to 2 years

Credit ratings are assessments by professional organisations of an entity's ability to punctually service and repay debt. Sector recommend individual limits and maximum investment periods for counterparties based on the quality of their credit ratings, to ensure an appropriate spread of credit risk. Organisations on our counterparty list are checked against Sector's monthly credit rating report and removed or altered if their credit ratings change. We receive daily e-mails from Sector advising us of any changes which are acted upon immediately. We also receive advice from Sector on the Sovereign ratings, status and prospects of individual countries, which we also act upon immediately. A recent example of this is Ireland, which we removed from our counterparty list upon the advice of Sector even though the Sovereign rating was unchanged.

7.5 We will also pay regard to the diversification of risk across Countries as well as individual institutions and will ensure that, with the exception of the UK, not too high a proportion of total investments are with any one Country. It is considered that this approach should combine limitation of risk with sufficient flexibility to enable the treasury function to operate effectively.

7.6 Much of the Council investment activity is in the form of short term fixed rate deposits which are classified by the Department of Communities and Local Government as "specified investments". As part of the investment strategy it is also proposed to invest in non-specified investments as follows:

- a) deposits in excess of one year where interest rates are attractive up to a maximum of £15m
- b) these long term deposits to include structured deposits were appropriate (structured deposits tend to earn higher interest but give the counterparty the option to cancel the loan part way through the term)

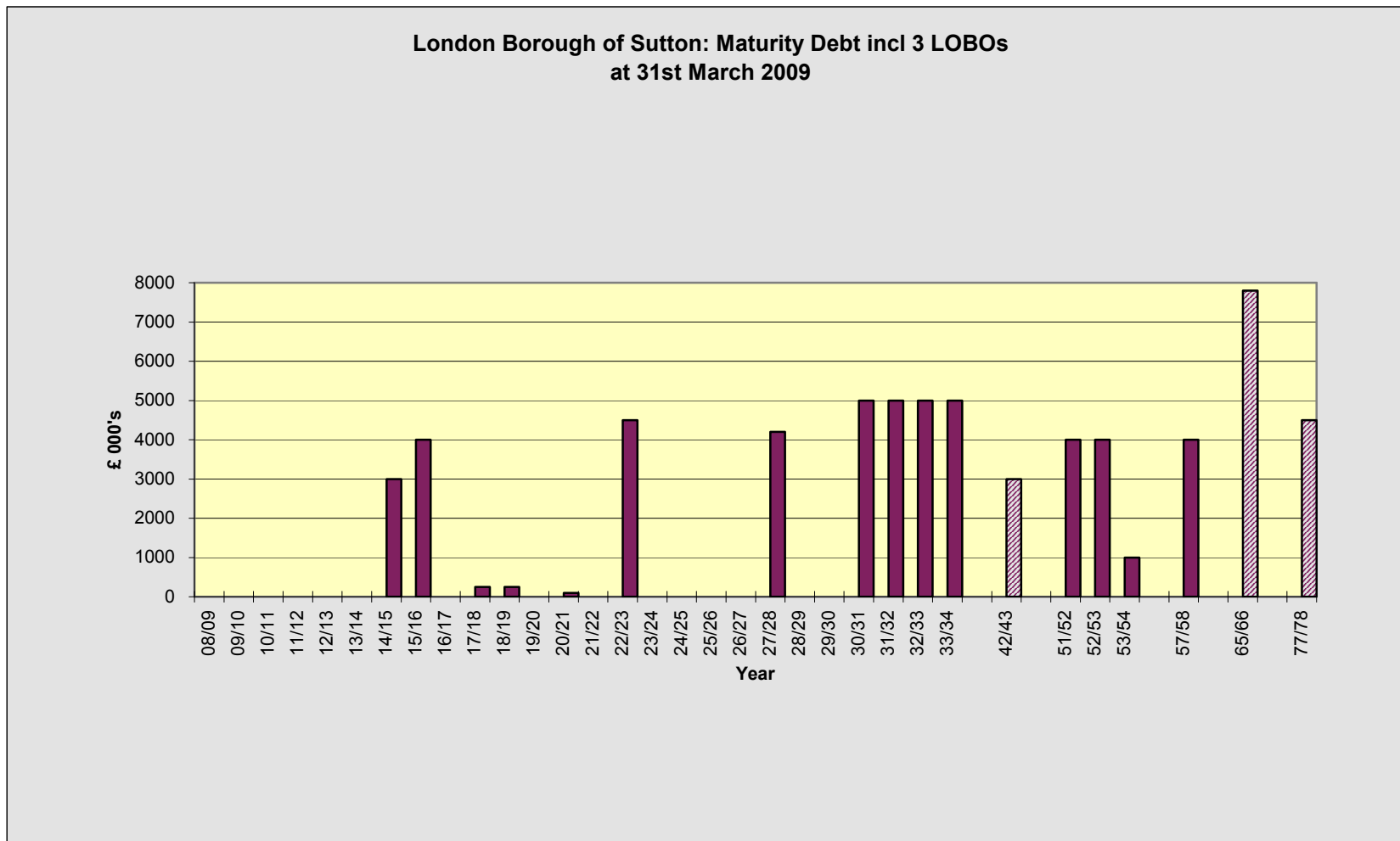
- c) to give more flexibility around debt restructuring following the PWLB changes outlined in paragraph 3.4 the Council may also invest in Gilts as part of debt restructuring packages proposed by Sector.


- 7.7 Fluctuations in the Council's cash flow profile through the financial year mean there will be significant amounts to invest at different periods during the year, annex TM4 shows the fluctuations on a day to day basis. During 2008/09 our investment of surplus funds has fluctuated between a maximum of £85m and a minimum of £33m.
- 7.8 The Council will continue to invest short-term surplus funds with either our money market fund, with Barclays Bank, our Business Reserve accounts or other institutions for periods ranging from overnight upwards to secure the best returns. As long term borrowing rates are expected to be higher than the rates achievable on investment income for the next couple of years, consideration may be given in appropriate circumstances to using longer term surplus funds to repay debt early. This could also have benefits in reducing our cash balances and therefore our exposure to interest rate and credit risk.
- 7.9 My recommendation is that the Council should avoid locking into long term deals while investment rates are down at historically low levels. We will utilise our business reserve accounts and keep the majority of investments short within a three months timeframe in order to benefit from the compounding of interest. Any investments made will be in line with the requirements of the Council's Treasury Management Policy Statement.
- 7.10 As part of the overall control of borrowing and investment I report performance against targets on a six-monthly basis. We benchmark our investment performance against the average of the 7 day LIBID and 3 month LIBID rate (3.5 refers). I also report to each meeting of The Executive on progress with the recovery of monies frozen in Heritable Bank plc.

ANNEX TM1

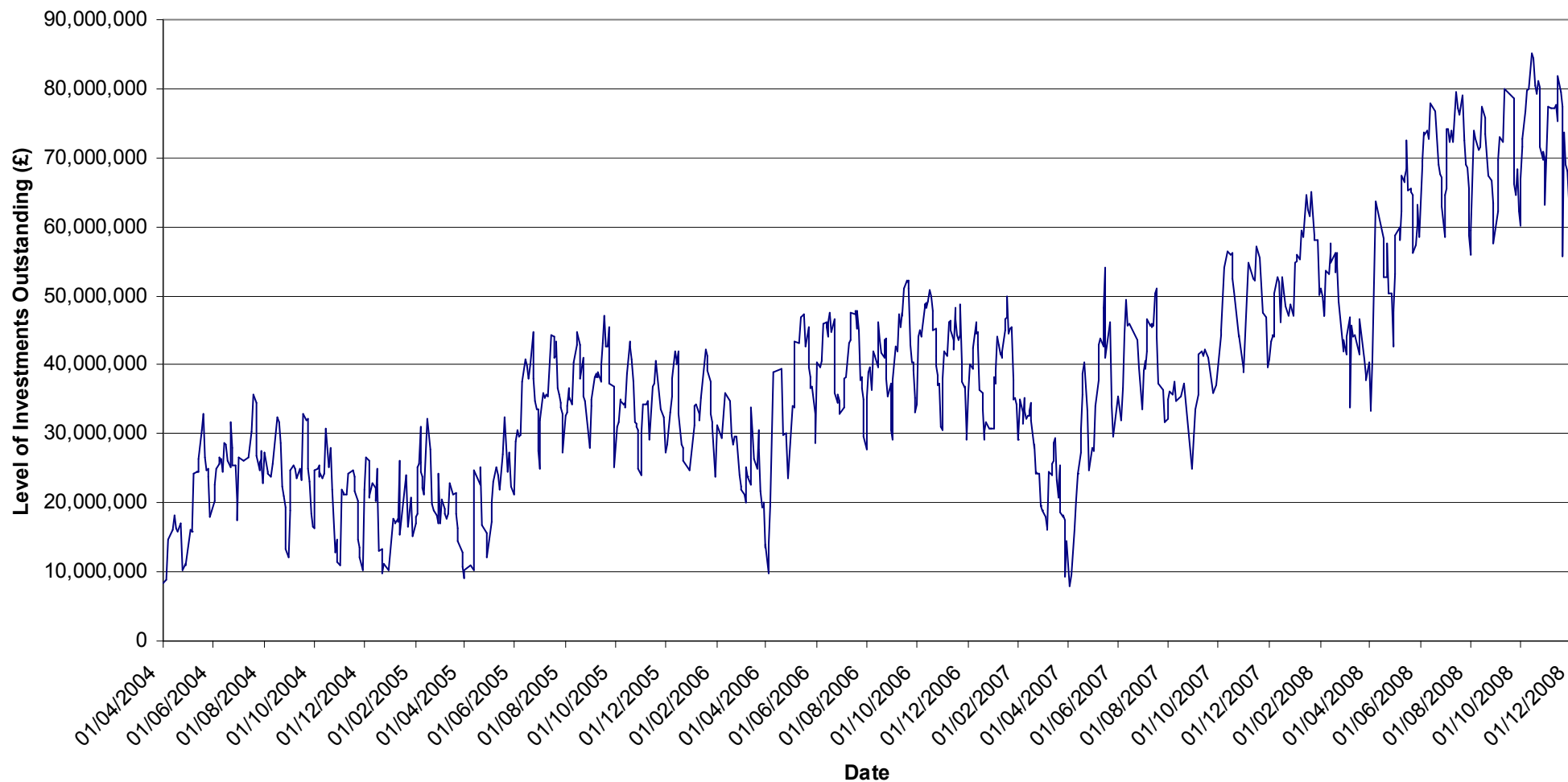
	2007/08	2008/09	2009/10	2010/11	2011/12
STATUTORY PRUDENTIAL INDICATORS (to support the Council's capital financing borrowing requirement)	£000	£000	£000	£000	£000
	<i>Actual</i>	<i>Estimate</i>	<i>Estimate</i>	<i>Estimate</i>	<i>Estimate</i>
Capital Expenditure: -					
Non – HRA	26,173	43,400	78,700	35,800	8,100
HRA	6,278	8,700	6,600	6,100	6,100
Total	32,451	52,100	85,300	41,900	14,200
Ratio of financing costs to net revenue stream:-					
Non – HRA	2.19	1.95	2.44	2.55	2.32
HRA	(0.75)	(0.42)	(0.03)	0.14	0.27
Capital Financing Requirement as at 31 March : -					
Non – HRA	99,294	111,800	119,600	116,600	115,000
HRA	-4,625	-1,000	700	2,000	3,200
Total	94,669	110,800	120,300	118,600	118,200
Annual change in Capital Financing Requirement					
Brought forward 1 April	85,235	94,700	110,800	120,300	118,600
Carried forward 31 March	94,669	110,800	120,300	118,600	118,200
	9,434	16,100	9,500	-1,700	-400
Incremental impact of capital investment decisions					
Increase in council tax (band D) per annum	0.00	0.00	0.00	0.00	0.48
Increase in average housing rent per week	0.00	0.00	0.00	0.00	0.00
Adoption of the CIPFA Code of Practice	The Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Services (Minute 389/02).				

	2007/08	2008/09	2009/10	2010/11	2011/12
STATUTORY TREASURY MANAGEMENT INDICATORS	£000	£000	£000	£000	£000
	<i>Actual</i>	<i>Estimate</i>	<i>Estimate</i>	<i>Estimate</i>	<i>Estimate</i>
Authorised limit for external debt: -					
Borrowing	92,030	108,200	117,700	115,900	115,500
Other long term liabilities	2,639	2,600	2,600	2,700	2,700
Total	94,669	110,800	120,300	118,600	118,200
Operational boundary for external debt:-					
Borrowing	65,280	73,100	74,400	76,400	76,500
Other long term liabilities	2,639	2,600	2,600	2,700	2,700
Total	67,919	75,700	77,000	79,100	79,200
Annual borrowing requirement based on Operational boundary					
Total			1,300	2,100	100
Interest Rate exposure					
Upper limit for fixed rate exposure	57,780	110,800	120,300	118,600	118,200
Upper limit for variable rate exposure	-32,850	27,700	30,100	29,700	29,600
Upper Limit on investments in excess of one year		15,000	15,000	15,000	15,000
Maturity Structure of fixed rate borrowing					
	Upper Limit		Lower Limit		
Under 12 months	15%		0%		
12 months and within 24 months	15%		0%		
24 months and within 5 years	45%		0%		
5 years and within 10 years	75%		0%		
10 years and above	100%		0%		
Maturity Structure	In addition to the limits set out above, a maximum of 15% of total debt maturing in one year.				
Temporary Borrowing Limit					
20% of the operational boundary	0	14,700	15,000	15,400	15,400



The  shaded columns show the maturity dates for the 3 LOBOs, the secondary periods commence in 2006/07, 2008/09 and 2009/10 respectively.

Council cash balances available for investment.



MINIMUM REVENUE PROVISION POLICY STATEMENT 2009/10

The Council will implement the new Minimum Revenue Provision (MRP) guidance in 2008/09, and assess their MRP in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

The guidance includes specific Options Local Authorities could use for calculating MRP:

- Option 1 – Regulatory Method – For expenditure incurred before 1st April 2008 and expenditure incurred on or after that date which is Supported expenditure. MRP is equal to an amount determined in accordance to the former regulations, which broadly equates to 4%
- Option 2 – Capital Financing Requirement (CFR) Method - For expenditure incurred before 1st April 2008 and expenditure incurred on or after that date which is Supported expenditure. MRP is equal to 4% of the non-housing capital finance requirement
- Option 3 – Asset Life Method – For capital expenditure financed by unsupported borrowing on or after 1st April 2008. MRP is based on the life of the asset either using the Equal Instalment method or Annuity method.
- Option 4 – Depreciation Method - For capital expenditure financed by unsupported borrowing on or after 1st April 2008. MRP is calculated in accordance with the standard rules for depreciation.

Capital expenditure incurred before 1 April 2008 and future Supported Capital Expenditure will continue to be charged at the rate of 4%, in accordance with Option 1 of the guidance. Capital expenditure incurred on or after 1st April 2008 which is funded from unsupported borrowing will be subject to MRP under Option 3 Asset Life Method, which will be charged over a period which is based on the estimated useful life of the assets, using the equal annual instalment method. For example, capital expenditure on a new building, or on the refurbishment or enhancement of a building, will be related to the estimated life of that building.

Estimated life periods will be determined under delegated powers. To the extent that expenditure is not on the creation of an asset and is of a type that is subject to estimated life periods that are referred to in the guidance, these periods will generally be adopted by the Council. However, the Council reserves the right to determine useful life periods and prudent MRP in exceptional circumstances where the recommendations of the guidance would not be appropriate.

As some types of capital expenditure incurred by the Council are not capable of being related to an individual asset, asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure. Also, whatever type of expenditure is involved, it will be grouped together in a manner which reflects the nature of the main component of expenditure and will only be divided up in cases where there are two or more major components with substantially different useful economic lives.

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