

Treasury Management Strategy for 2010-11

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 investment and cash management services 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) that the counterparty lists attached at Annex 2 and 3 be approved for all new lending;
- (viii) that the Treasury Management indicators be approved;
- (ix) the use of Barclays as the Authority's bankers be noted.

1.0 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 2010-11 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.
- 1.3 In December 2009, CIPFA published a revised Treasury Management Code of Practice. In response to this change in the regulations the Police Authority Policy Statement and Treasury Management Practices (TMPs) have been updated and are included elsewhere on this agenda. This Strategy complies with the new CIPFA code and the proposed Police Authority Policy Statement and TMPs.

2.0 Objectives for Treasury Management Activity

The Police Authority's objectives for Treasury management both investing and borrowing are as follows:

- effective management and control of risk is the prime objective.

- the Authority attaches a high priority to revenue cost stability. This aids stable financial planning and avoids a stop-start approach to service delivery. This means it adopts a relatively low-risk attitude to treasury management, and accepts that this may come at a cost.
- the main risks with regard to treasury management activities are security, liquidity and yield risk. The Authority's treasury management policies will prioritise the risks in that order of importance, that is highest priority will be given to security, followed by liquidity and then yield.
- the Authority will pursue best value in treasury management within the context of effective risk management.

3.0 Long Term Debt

3.1 Long term borrowing may only be incurred for the purpose of funding capital expenditure. The table below gives details of long term external debt.

	As at 31 March 2009		As at 31 Dec 2010	
	£000	Interest Rate %	£000	Interest Rate %
Fixed Rate Debt with Public Works Loan Board (PWLB)	24,277	4.12	28,777	4.09

3.2 Capital expenditure to be funded from borrowing is forecast at £9.8m in 2009/10 and £4.5m of new external borrowing has been taken on in 2009/10. It is not planned to increase debt further and the remaining capital expenditure will be funded from the Police Authority's cash balances (internal borrowing). This is a temporary measure – whilst short term interest rates are low and long term interest rates are higher it is advantageous to reduce cash balances and avoid new borrowing.

4.0 Schedule of Investments

4.1 The following schedule shows the Police Authority's fixed and variable rate investments as at 31 Dec 2010.

	As at 31 March 2009		As at 31 Dec 2010	
	£000	Interest Rate %	£000	Current Interest Rate %
Devon and Cornwall Police Investment Fund – Fixed Rate Deposits	20,000	4.90	13,500	3.70
Other cash investments				
Fixed Rate	3,725	0.35		
Variable Rate			3,674	0.70
Funds Managed by Investec	21,260	2.88	26,481	0.84
Total	44,985	4.67	43,655	1.65

- 4.2 Since autumn 2008, the investment performance of the Authorities cash has been hit by two major factors.
- a. the global banking sector crisis, where only radical measures by Governments around the world has kept the sector from total collapse, and
 - b. very low interest rates (as part of the measures used to alleviate the global credit crunch)
- 4.3 The former necessitated a review of the Authority's lending list, and the adoption of an even more prudent approach to counterparties to whom the Authority is willing to lend. The lending policy is kept under constant review and only a small number of selected UK Banks & Building Societies are currently being used.
- 4.4 The historically low level of interest rates mean that longer term cash deposits are not appropriate and the balance on the Devon and Cornwall Investment Fund is being progressively reduced as investments mature.
- 4.5 The overall effect of the two factors is that the return on the Authority cash investments is forecast to remain at low levels for the foreseeable future.

5.0 Prospects for Interest Rates

- 5.1 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.
- 5.2 Base rate forecasts from a number of sources, including the HM Treasury survey of City Institutions and Academics, have been reviewed. These indicate an end to very low short-term rates during 2010, the average forecast by City Institutions and Academics as at December 2010 is 1.3%.

Forecast Interest Rates

	Jan 2010	March 2010	June 2010	Sept 2010	Dec 2010
Base Rate	%	%	%	%	%
HM Treasury survey of City Institutions and Academics	0.5				1.30
Forecast Rates for Budget Purposes (Interest receipts)					
Short Term Cash (base rate forecast)		0.50	0.75	1.00	1.25
Investec Fund		1.25	1.25	1.25	1.25
Borrowing Rates (PWLB)					
20 year debt	4.52	4.90	5.00	5.00	5.00

- 5.3 The forecast rate for interest receipts for budgetary purposes is based on a gradual increase in rates across the year. The Police Authority's external fund managers Investec have provided forecasts in the range 1.25% to 2.0% for the funds they manage, the lowest forecast has been used for budgetary purposes.
- 5.4 An average rate of just under 2.0% has been used for forward year interest receipt forecast for 2011/12 and a rate of 2.0% has been used for 2012/13.

6.0 Capital Spending and Long Term Borrowing

- 6.1 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.
- 6.2 The Three Year Financial Strategy elsewhere on this agenda shows that borrowing required to fund the proposed capital programme is £10.957m.

Borrowing Strategy 2010-11 to 2012-13

- 6.3 The overall aims of the borrowing strategy are:
- borrowing at the lowest possible rates in the most appropriate periods
 - the minimum borrowing costs and expenses
 - management of debt maturities to avoid large levels of maturities in any one year.
- 6.4 Long-term borrowing rates are significantly above short-term lending rates. The current strategy with regard to borrowing for capital expenditure is to use internal cash balances (internal borrowing) as far as is possible and thus avoid external borrowing. The reason for this is:
- to minimise temporary cash balances whilst short-term interest rates are below borrowing rates
 - to reduce levels of investment whilst there is still some uncertainty about counterparties
- 6.5 The situation where long term rates are higher than short term rates is expected to continue for at least 12 months. In addition, long-term rates are forecast to increase over this period. For this reason no new external borrowing is planned for 2010/11. The Police Authority's cashflow model indicates that revenue cash balances will be sufficient to cover the capital expenditure. This situation can be described as "internal borrowing" where the Police Authority's revenue balances are temporarily "borrowed" to fund capital expenditure pending external borrowing at a later point. This strategy allows the Authority to make a relative saving over the short term by avoiding costly external borrowing. The risk associated with this strategy is that unplanned additional revenue expenditure will create a requirement for cash and the Authority will need to borrow to cover the cash requirement. This would cause additional revenue costs.
- 6.6 External borrowing will be required in 2011/12 and 2012/13 based on the proposed capital programme. The three year financial strategy assumes that this borrowing will be at an average of 5.0%.

7.0 Investment Strategy 2010-11 to 2012-13

- 7.1 The overall aims of the Police Authority's investment strategy are;
- To limit the risk of the loss of capital
 - Ensure funds are always available to meet cashflow requirements
 - Maximise investment returns consistent with the first two aims.

The overriding objective will be to invest prudently, with priority being given to security and liquidity before yield.

- 7.2 The Police Authority's risk appetite can be characterised as follows:
- the Police Authority looks for a high rating from banks and building societies and sets lending limits against each one
 - lending to other Local Authorities and Public Bodies is allowed, with differing credit limits according to the type of institution
 - the Police Authority will lend to the Debt Management Office (central government), this lending is seen as having the highest level of security
- 7.3 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. The proposed borrowing strategy, whereby there is no new external borrowing in 2010/11, represents a call on cash balances available to invest. It also means that there will be no external borrowing in advance of need. Investments are forecast to decline by approximately £10m over the 2010/11 financial year.
- 7.4 The Police Authority has three different mechanisms for investing surplus funds:
- Investments managed by Investec, the Authority's external fund managers (forecast balance as at 31 March 2010 - £21.7 million);
 - Devon and Cornwall Police Investment Fund managed by the Treasurer (forecast balance as at 31 March 2010 - £8.5 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

Allocation of funds as at 31 December 2009 between the different mechanisms is set out at paragraph 4.1. The allocation of funds will be determined by the Treasurer according to market conditions and appropriate risk management criteria and will be reported to the Resources Committee.

- 7.5 The same counterparties may be used by the Devon and Cornwall Police Investment Fund and the External Fund Manager. This means that the combined exposure to any given counterparty or group is the sum of the maximum limit for the Devon and Cornwall Investment Fund and the External Fund Manager.

- 7.6 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

- 7.7 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

External Fund Manager

- 7.8 The Authority employs Investec Asset Management to invest surplus funds. The agreement with the fund manager makes clear that the security of the fund is of paramount importance and the Manager's priority will be to minimise risk to capital values. The performance of Investec Asset Management is regularly monitored and reported to the Resources Committee. In addition compliance with the criteria laid down within the Annual Treasury Management Strategy is reviewed on a monthly basis. Ultimate responsibility for the security of the fund lies with the Police Authority.
- 7.9 Investec will use counterparties rated AA- or above. Although this is the minimum, investment will generally be with higher rated counterparties. The credit ratings agency used are Fitch IBCA and Standard and Poors. Investec use other information including credit default swap prices and market information to supplement the use of credit ratings.
- 7.10 All investments will be specified investments (as defined in the Local Authority Investment Regulations) 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 instructed the manager that any trades in supranational bonds must be discussed with him in advance.
- 7.11 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%.
- 7.12 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 and Short Term Cash Deposits

- 7.13 The Police Authority has a Service Level Agreement (SLA) with Devon County Council to provide Treasury Management Services. Under the SLA Devon County Council's Investment Team undertakes the day to day cash flow management on behalf of the Authority, provides advice to the Treasurer on investment of the Devon and Cornwall Police Investment fund and arranges any transactions that are agreed by the Treasurer. Ultimate responsibility for the security of the fund lies with the Police Authority.
- 7.14 The investment strategy for the Devon and Cornwall Police Investment Fund is set out in Annex 1. The investment fund will hold all cash investments of a duration of more than 3 months.
- 7.15 In order to meet the recommended practice set out in the new Treasury Management Code the Police Authority will adopt a new basis for judging the credit quality of Banks, UK Building Societies and other rated institutions. The ratings issued by all three of the major credit rating agencies, Fitch, Moody's and Standard & Poor's, are available to the Authority (and will be monitored daily). The lowest rating published by any of the agencies will be used to decide whether an institution is eligible for inclusion. This rating will also determine the maximum amount which can be loaned to an individual counterparty
- 7.16 Money Market Funds must have an 'AAA' rating, but are not currently being used. Other public sector bodies are principally arms of Government, or other local authorities and although not rated are deemed suitable counterparties because of their inherent low risk.
- 7.17 Below is a summary of the 'Approved List', the current policy is not to use it to its full extent and the approved counterparty list is attached as Annex 2. UK subsidiaries of foreign banks with a UK banking licence may be included.

Counterparty Type	Fitch	Moody's	Standard & Poor's	Credit Limit	
Banks					
UK Banks	not below	AA- & F1+	Aa3 & P-1	AA- & A-1	£6 million
	not below	A- & F1	A3 & P-1	A & A-1	£3 million
UK Building Societies					
	not below	AA- & F1+	Aa3 & P-1	AA- & A-1	£6 million
	not below	A- & F1	A3 & P-1	A & A-1	£3 million
Public Bodies					
Central Government					
					£25 million
Local Government					
					£3 million
					£3 million
					£3 million
					£3 million
					£3 million
					£1 million
					£1 million
Fire & Police Authorities					
					£1 million
Money Market Funds					
	AAA	Aaa	AAA		£6 million

- 7.18 The 'Approved List of Counterparties' specifies individual institutions, and is formally reviewed at least monthly. In the current environment, this takes place on a daily basis. Notification of credit rating downgrades (or other market intelligence) is acted upon immediately, resulting in any further lending being suspended.
- 7.19 All additions to the approved counterparty list will be approved by the Treasurer in consultation with the Chair of the Resources Committee and the Chair of Corporate Governance Committee. These will be reported retrospectively to the Resources Committee.
- 7.20 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 UK Building Societies, the Debt Management Deposit Facility, Local Authorities or pooled money market funds for more than 364 days.

Performance

- 7.21 The benchmark for performance for the external fund manager and the Investment fund will be the 7 day LIBID (London Interbank Rate).
- 7.22 The impact of the reduction in interest rates described in sections 4.0 and 5.0 above, when combined with the reduction in cash balances described in paragraph 7.3, is that interest receipts are expected to fall by £746,000 in 2010/11 as compared to 2009/10. The maturity of a number of long term deposits that were secured at relatively high interest rates in the first half of 2008 has had a particular impact.

8.0 Treasury Management Indicators

(i) Interest Rate Exposures

Upper limit on fixed and variable interest rate exposures for 2010-11 to 2012-13 are:-

This indicator sets a limit for the exposure to changes in interest rates.

Upper limit on fixed rate exposures	100%
Upper limit on variable rate exposures	20%

This means 80% - 100% of our borrowing will be at rates fixed until the loan is repayable, while no more than 20% will be at variable rates and so liable to change at short notice.

(ii) Maturity Structure of Borrowing

The amount of borrowing that is fixed rate and maturing in 10 years or above:

Upper limit	100%
Lower Limit	67%

This indicators shows a maximum of 33% of the authority's borrowing may be taken out for period of less than 10 years. The remaining debt will be for periods of 10 years or more.

(iii) Upper limit for principal sums invested for period of over 364 days.

This indicator sets a limit on the level of investments that are held for more than 364 days and for the level of investment to be held for longer periods.

The Treasury Management Strategy imposes the following controls on sums invested for more than 364 days:

Funds Invested by External Fund Manager - no more than 30% of the fund may be invested for period of more than 364 days

Devon and Cornwall Police Investment Fund - no more than the lesser of £10m or 50% of the fund may be invested for more than 364 days

The total for forecast investments as at 31 March 2010 is £36m

Limits on investments to mature beyond:

31 March 2011	£36.0m
31 March 2012	£10.0m
31 March 2013	£8.0m

9.0 Cash Flow

9.1 Cash flow within the Three Year Financial Strategy covers the three years to 2012-13. A cash flow 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.

10.0 Monitoring

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

10.2 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 2009.

11.0 Banking Arrangements

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

12.0 Conclusion

- 12.1 The outlook for 2010/11 is one of continuing difficulties in terms of Treasury Management performance. Interest rates that can be obtained from investments are at a record low and the recovery to more normal levels is likely to be slow. When this is combined with the reduction in reserves and hence cash balances, this has a significant impact on the revenue budget and there is a decline of £746,000 in interest receipts for 2010/11 as compared with 2009/10. This follows a £906,000 reduction in the budget for interest receipts in 2009/10.
- 12.2 Long term interest rates that apply to borrowing have not fallen to the same degree. The Police Authority has responded to this change in circumstances by changing its borrowing strategy and for 2010/11 the plan is that there will be no external borrowing in 2010/11. The authority will use its own revenue cash balances on a temporary basis to cover capital expenditure.
- 12.3 The global banking crisis has caused a change in the regulatory framework for Treasury Management and the Police Authority has responded by updating its Treasury Management Policy and Practices, Those changes are reflected in this Strategy.

Stephen Barrett
Treasurer

Contact for information: Angela Daveney, Head of Technical Accounting
angeladaveney@devonandcornwall.pnn.police.uk
01392 452361

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 counterparties 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.

DEVON AND CORNWALL POLICE AUTHORITY

APPROVED LIST OF BORROWERS

		DCPA Lending Limits	
		Counterparty	Group Limits
		£ millions	£ millions
1.	UK CLEARING BANKS & SUBSIDIARIES (GROUP Limit £)		
	BARCLAYS BANK	6	
	HSBC BANK	6	
	LLOYDS BANKING GROUP	3	
	ROYAL BANK OF SCOTLAND	3	
	SANTANDER	6	
2.	BUILDING SOCIETIES		
	NATIONWIDE	3	
	LEEDS	3	
3.	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	
4.	DEBT MANAGEMENT ACCOUNT (CENTRAL GOVERNMENT)		
	DMA Deposit Facility (DMADF)		25

Annex 3

Lending List for External Fund Manager

As at 30 January 2010

Counterparty	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 manger may also invest in supranational bonds and in other overseas institutions after specific agreement by the Police Authority Treasurer.

*UK subsidiaries of the Spanish bank, Banco Santander Central Hispano