

## **REPORT ON THE REVISIONS TO THE TREASURY MANAGEMENT STRATEGY STATEMENT AND INVESTMENT STRATEGY 2012/13 TO 2014/15**

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### **SUMMARY**

Audit Committee considered the draft Annual Treasury Management Strategy Statement and Investment Strategy for 2012/13 to 2014/15 at the December 2011 meeting. This was in advance of the final Statement being presented to Cabinet and Council on 23 February 2012.

As part of the scrutiny process members requested that a further report should be brought to the March Audit Committee detailing the changes from the draft to the final version of the Statement.

### **RECOMMENDATIONS**

That the contents of the report are noted.

### **INFORMATION – Amendments to the Annual Treasury Management Strategy Statement and Investment Strategy for 2012/13 to 2014/15**

Since the draft TMSS was reported to Audit Committee in December, the final Housing Revenue Account determination has been published, changing Hillingdon's payment from £192.8m to £191.6m. As a result several figures within the report have been amended. In addition, the section discussing the 'Reform to the Council Housing Subsidy System' has been rewritten and now covers paragraphs 2.7 to 2.13 (previously 2.7 to 2.8).

Certain figures within the report have been updated as a result of movements over the last couple of months due to the completion of the Council's capital programme for 2012/13 to 2014/15, updates to estimated debt maturities and to match the latest budget position.

Prior to taking the report to Cabinet it was noticed that one change which had been included in the strategy had not been highlighted in the summary. Therefore, the summary has been amended to highlight the change in minimum counterparty credit rating from A+ to A- to accommodate the downgrade of many UK financial institutions and to note the removal of Clydesdale Bank from the counterparty list. This change is in relation to the summary section only.

The appendices have also been updated to reflect the latest information.

All changes have been highlighted on the attached report.

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

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## SUMMARY

This report explains the context within which the Council's treasury management activity operates and sets out a proposed strategy for the coming year in relation to the Council's cash flow, investment and borrowing, and the strategy for managing the numerous risks related to this activity.

With an overall annual expenditure in excess of £700m and an extensive capital programme, the Council is required to actively manage its cash-flows on a daily basis. The requirement to invest or to borrow monies to finance capital programmes, and to cover daily operational needs, is an integral part of daily cash and investment portfolio management. As at 31 March 2012 the Council's loan portfolio is expected to be £165.2m (excluding Housing Revenue Account reform financing) and the total value of investments forecast at £38.4m. The Balance Sheet position as at 31 March 2011 showed the value of debt as £161.6m and the value of investments as £42.9m.

The Council's Capital Financing (CFR) requirement, which measures the Council's underlying need to borrow for capital purposes and represents the cumulative capital expenditure that has not yet been financed, is a key driver of borrowing strategy. Reform of the housing subsidy system has had major impact on the Housing Revenue Account (HRA) element of the CFR and will require the Council to take on additional debt of £191.6m to fund a one off settlement to central government in return for abolishing the annual subsidy payment. The projected CFR for 31 March 2012 is £429.7m, of which £161.7m is attributed to the General Fund (GF) with the remaining £268.0m within the HRA.

The Council's current strategy is to minimise borrowing to below the level of its net borrowing requirement. This is lower than the CFR, the difference representing balances, reserves, provisions and working capital. This approach lowers interest costs and reduces credit risk and relieves pressure on the Council's counterparty list. Borrowing is restricted to a few highly secure sources. These include: the Public Works Loan Board (PWLB), commercial banks, European Investment Bank, structured finance, and products associated with other local authorities. Additionally, borrowing is restricted by two limits: the Authorised Limit, a statutory limit that sets the maximum level of external borrowing on a gross basis, and the Operational Boundary, which is determined by both the estimated CFR and day to day cash flow movements. For 2012/13 the proposed Authorised Limit is £499m and proposed Operational Boundary is £466m.

Throughout the year, capital expenditure levels, market conditions and interest rate levels are monitored to minimise borrowing costs over the medium to longer term and maintain stability. The differential between debt costs and investment earnings continues to be acute, resulting in the use of internal resources in lieu of borrowing often being the most cost effective means of financing capital expenditure. An additional strand of the strategy is to actively monitor opportunities arising for debt rescheduling in order to deliver savings in interest costs but with minimal risk, and to balance the ratio of fixed rate to variable rate debt within the portfolio.

In order to service the Council's day to day cash needs, the Council maintains a portfolio of short term investments. The Council's investment priorities are: the security of invested capital; the liquidity of invested capital, and the optimum yield that is commensurate with security and liquidity, in that order. The report details the Council's investment strategy, explains the institutions (counterparties) with whom the Council is permitted to invest, the limits related to the size of individual investments and overall holding with institutions. In the annual review of the strategy a change to the minimum investment counterparty long term credit rating from A+ to A- (or equivalent) is recommended. This is in response to downgrades in the credit ratings below A+ of many institutions considered to be systemically important to the financial system. In addition several amendments to the investment options have been suggested. These include: the addition of Corporate Bonds, the addition of a new counterparty; Bank Nederlandse Gemeenten, a reduction in Money Market Fund limits (from £10m/15% to £7.5m/10%) and the removal of Clydesdale Bank from the counterparty list.

As a result of continued pressure and uncertainty within the financial markets, the security of any investment is the primary consideration in decision making and a cautious approach will always be adopted. Whilst this report identifies all permitted options in investment decision making, tighter controls govern daily activity limiting the number of counterparties with whom investments will be placed and the value of the total holding with any single institution. Regular monitoring of all institutions on the counterparty list is part of daily treasury management. In any period of significant stress in the markets, the default position will be to invest with the governments Debt Management Office (DMO).

The impact of interest rates is crucial to all treasury management activity and forecasts of interest rate movements are taken into account in developing treasury management strategy. Consequently this strategy is kept under review and, taking market information into account, will be realigned, if required, with evolving market conditions and expectations for future interest rates.

In November 2011 CIPFA revised its Treasury Management Code of Practice and these amendments have been incorporated within the Strategy and additionally a revised Treasury Management Policy Statement issued for approval.

## **1. Background**

- 1.1. The Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in Public Services (the "CIPFA TM Code") and the Prudential Code require local authorities to determine a Treasury Management Strategy Statement (TMSS) and Prudential Indicators on an annual basis. The TMSS also incorporates the Annual Investment Strategy as required under the CLG's Investment Guidance.
- 1.2. 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.

- 1.3. The purpose of this TMSS is to allow Council to approve:
  - Treasury Management Strategy for 2012/13
  - Annual Investment Strategy 2012/13
  - Prudential Indicators for 2012/13, 2013/14 and 2014/15
  - MRP Statement
  - Adoption of the revised Treasury Management Code of Practice & Guidance notes and subsequent amendments
- 1.4. The strategy takes into account the impact of the Council's Revenue Budget and Capital Programme on the Balance Sheet position, the Prudential Indicators and the current and projected Treasury position (Appendix A). The outlook for interest rates (Appendix B) has been taken into account in developing this strategy.
- 1.5. The CIPFA Treasury Management Code was revised in November 2011 and as per requirements of the Prudential Code, Council are asked to approve the adoption of the revised code.
- 1.6. All treasury activity will continue to comply with relevant statute, guidance and accounting standards.

## **2. Balance Sheet and Treasury Position**

- 2.1. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), which together with Balances and Reserves are the core drivers of treasury management activity. The estimates of the CFR, based on the current Revenue Budget and Capital Programmes, are:

	<b>2011/12 Estimate £m</b>	<b>2012/13 Estimate £m</b>	<b>2013/14 Estimate £m</b>	<b>2014/15 Estimate £m</b>
General Fund CFR	161.7	191.2	221.1	229.2
HRA CFR	268.0	268.0	268.0	268.0
<b>Total CFR</b>	<b>429.7</b>	<b>459.2</b>	<b>489.1</b>	<b>497.2</b>
<b>Less:</b> Existing Profile of Borrowing and Other Long Term Liabilities *	168.1	160.9	153.9	147.9
<b>Cumulative Maximum External Borrowing Requirement</b>	<b>261.6</b>	<b>298.3</b>	<b>335.2</b>	<b>349.3</b>
Balances & Reserves**	29.8	26.5	23.9	24.1
<b>Cumulative Net Borrowing Requirement/(Investments)</b>	<b>231.8</b>	<b>271.8</b>	<b>311.3</b>	<b>325.2</b>

The \*

existing profile of borrowing and other long term liabilities does not include potential LOBO loan maturities which may or may not occur. Over the next three years, loans totalling £8m, £10m and £11m respectively will be in their call state.

\*\*In order to demonstrate a prudent net borrowing position the Balances and Reserves figures quoted above relate to core General Fund balances only and do not include those balances over which the Council has no direct control.

- 2.2. The Council's level of physical debt and investments are linked to these components of the Balance Sheet. The current portfolio position is set out at Appendix A. Market conditions, interest rate expectations and credit risk considerations will influence the Council's strategy in determining the borrowing and investment activity against the underlying Balance Sheet position. The Council will ensure that net physical external borrowing (i.e. net of investments) will not exceed the CFR other than for short term cash flow requirements.

#### Estimates of Capital Expenditure:

- 2.3. It is a requirement of the Prudential Code to ensure that capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council Tax and in the case of the HRA, housing rent levels.
- 2.4. For the purposes of Treasury management the estimates for capital expenditure shown in the next table vary from the draft budget. Figures presented here are an estimate of likely capital cash outflows whereas the capital budget is set on an accruals basis.

Capital	2011/12	2011/12	2012/13	2013/14	2014/15
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Expenditure	Approved £m	Revised £m	Estimate £m	Estimate £m	Estimate £m
General Fund	61.8	51.4	87.3	71.1	37.0
HRA	11.9	13.4	17.9	13.7	7.0
<b>Total</b>	<b>73.7</b>	<b>64.8</b>	<b>105.2</b>	<b>84.8</b>	<b>44.0</b>

2.5. Capital expenditure is expected to be financed as follows:

Capital Financing	2011/12 Approved £m	2011/12 Revised £m	2012/13 Estimate £m	2013/14 Estimate £m	2014/15 Estimate £m
Capital Receipts	20.9	15.0	15.5	12.7	0
Government Grants	24.7	25.8	36.8	18.7	17.7
Revenue Contributions	1.9	2.1	2.4	3.5	3.5
Other External Funding	3.0	5.3	3.3	5.8	3.9
Unsupported Borrowing	23.2	16.6	47.2	44.1	18.9
<b>Total</b>	<b>73.7</b>	<b>64.8</b>	<b>105.2</b>	<b>84.8</b>	<b>44.0</b>

#### Incremental Impact of Capital Investment Decisions:

2.6. As an indicator of affordability the table below shows the notional impact of capital investment decisions on Council Tax and housing rent levels and represent the impact on these if the financing of the capital programme were to be funded from taxes and rents. However, in reality much of the capital programme is funded from the sale of released or newly created assets, revenue savings for invest to save schemes and additional rental income for HRA developments.

Incremental Impact of Capital Investment Decisions	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Increase in Band D Council Tax	£21.96	£22.05	£15.78
Increase in Average Weekly Housing Rents	£5.02	£(0.01)	£0.22

#### Reform to the Council Housing Subsidy System

2.7. The Council housing self-financing reforms involve the removal of the housing subsidy system by transferring a one-off allocation of national housing debt in return for the retention of all rental income that is currently pooled under the subsidy regime. Settlement date is 28<sup>th</sup> March 2012 and will result in the Council more than doubling it's debt to fund the settlement figure of £191.6m in return for an annual subsidy payment to central government that currently amounts to £15m per annum.

- 2.8. New Borrowing from 1<sup>st</sup> April 2012 will be allocated to the relevant GF and HRA debt pools. Pre-settlement loans will be frozen at 31<sup>st</sup> March 2012 and will be allocated to the two pools to align historic debt to GF and HRA respectively.
- 2.9. The Council has the option of borrowing externally from the PWLB or the market and will, in conjunction with treasury advisors, seek a mix of financial instruments that spreads Treasury risks. In a departure from current Treasury practice the Council will adopt a two pool approach in relation to the allocation of debt between the GF and the HRA.
- 2.10. A two pool approach involves splitting existing loans between the GF and HRA and then allocating new loans to each pool as required. This has been adopted for clarity and transparency. Treasury management decisions on the structure, timing of borrowing and debt management will be made independently for the GF and HRA. Interest on loans will be calculated in accordance with proper accounting practices. Interest expenditure on external borrowing will be attributed to GF and HRA accordingly.
- 2.11. The policy for apportioning existing loans is based on matching actual HRA capital expenditure with actual borrowing.
- 2.12. If the GF and HRA wish to swap loans as a result of strategic decisions this will be undertaken at no internal premium or discount.
- 2.13. Where the GF or HRA has surplus cash balances which allow either account to have external borrowing below its level of CFR, the rate charged on this internal borrowing will be based on the average rate of interest earned on cash balances for the financial year.
- 2.14. **HRA Indebtedness:** As a requirement of the Prudential Code a limit of £303.3m has been set for HRA indebtedness for 2012/13 and the following two years.
- 2.15. The ratio of financing costs to the Council's net revenue stream 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 borrowing costs. The ratio is based on costs net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2011/12 Approved %	2011/12 Revised %	2012/13 Estimate %	2013/14 Estimate %	2014/15 Estimate %
General Fund	4.25	2.92	4.00	5.08	5.85
HRA	31.17	30.80	28.11	27.24	26.61
<b>Weighted Average</b>	<b>9.99</b>	<b>8.64</b>	<b>9.07</b>	<b>9.88</b>	<b>10.46</b>



### 3. Borrowing and Rescheduling Strategy

- 3.1. The Council's balance of estimated external debt at **31 March 2012** (gross borrowing plus other long term liabilities) is shown in Appendix A. This Prudential Indicator is comparable with the Operational Boundary and Authorised Limit.
- 3.2. The **Authorised Limit** sets the maximum level of external borrowing on a gross basis (i.e. not net of investments) and is the statutory limit for borrowing determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit).

<b>Authorised Limit for External Debt</b>	<b>2011/12 Approved £m</b>	<b>2011/12 Revised £m</b>	<b>2012/13 Estimate £m</b>	<b>2013/14 Estimate £m</b>	<b>2014/15 Estimate £m</b>
Borrowing	489	489	496	527	535
Other Long term Liabilities	3	3	3	2	2
<b>Authorised Limit</b>	<b>492</b>	<b>492</b>	<b>499</b>	<b>529</b>	<b>537</b>

- 3.3. The **Operational Boundary** is linked directly to the Council's estimates of the CFR and estimates of other day to day 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.

<b>Operational Boundary for External Debt</b>	<b>2011/12 Approved £m</b>	<b>2011/12 Revised £m</b>	<b>2012/13 Estimate £m</b>	<b>2013/14 Estimate £m</b>	<b>2014/15 Estimate £m</b>
Borrowing	459	459	466	497	505
Other Long term Liabilities	3	3	3	2	2
<b>Operational Boundary</b>	<b>462</b>	<b>462</b>	<b>469</b>	<b>499</b>	<b>507</b>

- 3.4. The Chief Finance Officer has delegated authority, within the above limits 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. Council will be notified of any use of this delegated authority.
- 3.5. **Gross and Net Debt:** - a new indicator will be included once final guidance is clarified.
- 3.6. In conjunction with advice from its treasury advisor, Arlingclose, the Council will keep under review the following borrowing options:

- Public Works Loan Board (PWLB) loans
  - Borrowing from other local authorities
  - Borrowing from institutions such as the European Investment Bank and directly from Commercial Institutions
  - Borrowing from the Money Markets
  - Capital Markets (stock issues, commercial paper and bills)
  - Local authority bills
  - Structured finance
  - Leasing
- 3.7. Notwithstanding the issuance of Circular 147 on 20 October 2010, following the CSR announcement which increases the cost of new local authority loans from the PWLB to 1% above the cost of the Government gilts, PWLB still remains an attractive source of borrowing, given the transparency and control its facilities continue to provide. The types of PWLB borrowing that are considered appropriate for a low interest rate environment are:
- Variable rate borrowing
  - Medium-term Equal Instalments of Principal (EIP) or Annuity Loans
  - Long term Maturity loans, where affordable

Capital expenditure levels, market conditions and interest rate levels will be monitored during the year in order to minimise borrowing costs over the medium to longer term and maintain stability. The differential between debt costs and investment earnings, despite long term borrowing rates being at low levels, remains acute and this is expected to remain a feature during 2012/13. The “cost of carry” associated with medium and long term borrowing compared to temporary investment returns means that new fixed rate borrowing could entail additional short term costs. The use of internal resources in lieu of borrowing may again, in 2012/13, be the most cost effective means of financing capital expenditure.

- 3.8. PWLB variable rates are expected to remain low as the Bank Rate is maintained at historically low levels for an extended period. Exposure to variable interest rates will be kept under regular review. Each time the spread between long term rates and variable rates narrows by 0.50%, Arlingclose will trigger a formal review point with the Council and options will be considered and decisions taken on whether to retain the same exposure or change from variable to fixed rate debt.
- 3.9. The Council’s existing PWLB variable rate loan borrowed prior to 20 October 2010 will be maintained on its initial terms and is not subject to the additional increased margin for new variable rate loans.
- 3.10. HRA Reform Financing – On the 20 September 2011, HM Treasury announced the PWLB rates offered to local authorities would be temporarily reduced to allow councils

to borrow at lower levels for their one-off HRA reform settlement payment. This will enable the Council to borrow at around 0.13% above the equivalent gilt yield (current borrowing rates are 1% above the gilt yield) to fund the HRA transaction. These lower rates will be available on 26<sup>th</sup> March 2012 only. Although various sources of borrowing will be considered, it is likely that due to the temporary reduction, all HRA reform financing will be sourced from the PWLB utilising a mix of variable and fixed rate loans with varying maturities.

- 3.11. The Council has £48m loans, which are LOBO loans (Lender's Options Borrower's Option) of which £8m of loans will be in their call period in 2012/13. In the event that the lender exercises the option to change the rate or terms of the loan, the Council will consider the terms being provided and also repayment of the loan without penalty. The Council may utilise cash resources for repayment or may consider replacing the loan(s) by borrowing from the PWLB. The default response will however be early repayment without penalty.
- 3.12. There is a significant difference between the gross external borrowing requirement and the net external borrowing requirement represented by the Council's level of balances, reserves, provisions and working capital. The Council's current strategy is only to borrow to the level of its net borrowing requirement. The reasons for this are to reduce credit risk, take pressure off the Council's lending list and also to avoid the cost of carry existing in the current interest rate environment.
- 3.13. The rationale for rescheduling would be one or more of the following:
- Savings in interest costs with minimal risk
  - Balancing the volatility profile (i.e. the ratio of fixed to variable rate debt) of the debt portfolio
  - Amending the profile of maturing debt to reduce any inherent refinancing risks.

Rates and markets are monitored daily by officers to identify opportunities for rescheduling.

- 3.14. Borrowing and rescheduling activity will be reported monthly to Cabinet.
- 3.15. Where temporary borrowing is required this will be attributed directly to either the GF or HRA as needed. Interest costs will be allocated accordingly.
- 3.16. The following Prudential Indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. The upper limit for variable rate exposure has been set to ensure that the Council is not exposed to interest rate rises, which could adversely impact on the revenue budget. The limit allows for the use of variable rate debt to offset exposure to changes in short term rates on investments.

Upper Limits for Interest Rate Exposure	Estimated Level (or benchmark level at 31/03/12 %)	2011/12 Revised %	2012/13 Estimate %	2013/14 Estimate %	2014/15 Estimate %
Upper Limit for Fixed Interest Rate Exposure on Debt	85	100	100	100	100
Upper Limit for Fixed Interest Rate Exposure on Investments	0	(75)	(75)	(75)	(75)
Upper Limit for Variable Interest Rate Exposure on Debt	15	50	50	50	50
Upper Limit for Variable Interest Rate Exposure on Investments	(100)	(100)	(100)	(100)	(100)

For the purposes of the above indicator investments over one year in duration are classified as fixed.

- 3.17. The Council will also limit and monitor large concentrations of fixed rate debt needing to be replaced. Limits in the following table are intended to control excessive exposures to volatility in interest rates when refinancing maturing debt. The first scheduled LOBO call option has been included as the maturity date within this indicator.

Maturity structure of fixed rate borrowing	PWLB Estimated level (Benchmark level) at 31/03/12 %	Market LOBO 1 <sup>st</sup> call option at 31/03/12 %	Lower Limit for 2012/13 %	Upper Limit for 2012/13 %
under 12 months	3.44	5.22	0	25
12 months and within 24 months	3.44	6.53	0	25
24 months and within 5 years	7.54	10.44	0	50
5 years and within 10 years	32.31	9.14	0	100
10 years and within 20 years	3.26	0	0	100
20 years and within 30 years	0.00	0	0	100
30 years and within 40 years	0.00	0	0	100

40 years and within 50 years	18.68	0	0	100
50 years and above	0	0	0	100

#### 4. Investment Policy and Strategy

- 4.1. Guidance from CLG on Local Government Investments in England requires that an Annual Investment Strategy (AIS) be set.
- 4.2. The Council's investment priorities are:
- security of the invested capital;
  - liquidity of the invested capital;
  - an optimum yield which is commensurate with security and liquidity.
- 4.3. Investments are categorised as 'Specified' or 'Non Specified' investments based on the criteria in the CLG Guidance. Potential instruments for the Council's use within its investment strategy are contained in Appendices C and D. The Chief Finance Officer, under delegated powers, will undertake the most appropriate form of investments in keeping with the investment objectives, income and risk management requirements and Prudential Indicators. Decisions taken on the core investment portfolio will be reported monthly to Cabinet.
- 4.4. 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 lead to a sovereign debt crisis and a banking crisis with the outcome still largely unknown. It is against this backdrop of uncertainty that the Council's investment strategy is framed.
- 4.5. Changes implemented to the investment strategy for 2012/13 include:
- The addition of corporate bonds which the CLG have indicated will become eligible as non-capital investments from 01/04/12
  - The addition of Bank Nederlandse Gemeenten (Long term rating AAA/AAA/Aaa)
  - Reduction of MMF limits from 15%/£10m to 10%/£7.5m
  - Removal of Clydesdale Bank from the Counterparty list
- 4.6. The Council's estimated level of investments at 31 March 2012 is presented at Appendix A.
- 4.7. The Council's in-house investments are made with reference to the outlook for the UK Bank Rate and money market rates.

- 4.8. In any period of significant stress in the markets, the default position is for investments to be made with the Debt Management Office (DMO) or UK Treasury Bills. (The rates of interest from the DMO are below equivalent money market rates, but the returns are an acceptable trade-off for the guarantee that the Council's capital is secure)
- 4.9. Investment returns attributable to the HRA will be based on the Item 8 determination
- 4.10. **Credit Risk:** The Council considers security, liquidity and yield, in that order when making investment decisions. Credit ratings remain an important element of assessing credit risk but they are not the sole feature in the Council's assessment of counterparty credit risk. The Council 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.
- Credit Ratings - minimum long term A- or equivalent for counterparties; AA+ for non-UK sovereigns. (The counterparty limit is lower than the A+ minimum adopted in 2011/12 and is in response to downgrades in the credit ratings below A+ of many institutions considered to be systemically important to the financial system)
  - Credit Default Swaps (where quoted)
  - Economic fundamentals such as GDP; Net Debt as a Percentage of GDP
  - Sovereign support mechanisms/potential support from a well-resourced parent institution
  - Share Prices (where quoted)
  - Macro-economic indicators
  - Corporate developments, news articles and market sentiment.
  - Subjective overlay

The Council will continue to analyse and monitor these indicators and credit developments on a regular basis and respond as necessary to ensure security of the capital sums invested.

- 4.11. The UK Bank Rate has been maintained at 0.5% since March 2009, and is anticipated to remain at low levels throughout 2012/13. Short term money market rates are likely to remain at very low levels for an extended period, which will have a significant impact on investment income.
- 4.12. With short term interest rates low for even longer, an investment strategy will typically result in a lengthening of investment periods, where cash flow and credit conditions permit, in order to lock in higher rates of acceptable risk adjusted returns.
- 4.13. In order to spread 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.

- 4.14. Money market funds (MMFs) will be utilised, but good treasury management practice prevails and whilst MMFs provide good diversification the Council will also seek to diversify any exposure by utilising more than one MMF. The Council will also restrict its exposure to MMFs with lower levels of funds under management and will not exceed 0.5% of the net asset value of the MMF. Where MMF's participate, the Council utilises the facilities of a MMF portal to make subscriptions and redemptions. The portal procedure involves the use a clearing agent however the Council's funds are ring fenced throughout the process.
- 4.15. Collective Investment Schemes (Pooled Funds): The Council has evaluated the use of Pooled Funds and determined the appropriateness of their use within the investment portfolio. Pooled funds enable the Council to diversify the assets and the underlying risk in the investment portfolio and provide the potential for enhanced returns. Any investment in pooled funds will be regularly monitored for both performance and to ensure their continued suitability in meeting the Council's investment objectives.
- 4.16. Investments which constitute capital expenditure: Investments meeting the definition of capital expenditure can be financed from capital or revenue resources. They are also subject to the CLG's Guidance on "non-specified investments". Placing of such investments has accounting, financing and budgetary implications. Whilst it is permissible to fund capital investments by increasing the underlying need to borrow, it should be noted that under the CLG's Minimum Revenue Provision (MRP) Guidance, MRP should be applied over a 20 year period. The Council has determined that it is not currently prudent to make investments which constitute capital expenditure. These would presently need to be sourced from revenue and therefore the requirement for MRP would make the investment not viable.
- 4.17. The use of financial instruments for the management of risks: Currently, Local 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 Council does not intend to use derivatives. Should this position change, the Council may seek to develop a detailed and robust risk management framework governing the use of derivatives, but this change in strategy will require full Council approval.
- 4.18. The Council banks with HSBC Bank plc and at the current time, it does meet the minimum credit criteria of A- (or equivalent) long term. If the credit rating falls below the Authority's minimum criteria, HSBC Bank plc will continue to be used for its banking activities, short term liquidity requirements (overnight and weekend investments) and business continuity arrangements.

4.19. The Council has placed an upper limit for principal sums invested for over 364 days, as required by the Prudential Code. This limit is to contain exposure to the possibility of loss that may arise as a result of the Council having to seek early repayment of the sums invested.

Upper Limit for total principal sums invested over 364 days	2011/12 Approved £m	2011/12 Revised £m	2012/13 Estimate £m	2013/14 Estimate £m	2014/15 Estimate £m
	17	17	80	53	26

4.20. All investment activity will comply with the accounting requirements of the local authority IFRS based Code of Practice.

## 5. Outlook for Interest Rates

The economic interest rate outlook provided by the Council's treasury advisor, Arlingclose, is attached at Appendix B. The Council also monitors other sources of market information and will reappraise its strategy from time to time and, if required, realign it with evolving market conditions and expectations for future interest rates.

## 6. Balanced Budget Requirement

6.1. The Council complies with the provisions of S32 of the Local Government Finance Act 1992 to set a balanced budget.

## 7. 2012/13 MRP Statement

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

7.2. The four MRP options available are:  
 Option 1: Regulatory Method  
 Option 2: CFR Method  
 Option 3: Asset Life Method  
 Option 4: Depreciation Method

This does not preclude other prudent methods to provide for the repayment of debt principal.



- 7.3. MRP in 2012/13: Option 1 and 2 will be used for the majority of GF historic debt particularly that deemed to be supported through the Revenue Support Grant. For major projects where capital expenditure is funded from prudential borrowing Option 3 will be used to provide MRP over the life of the asset to which the borrowing was applied.
- 7.4. Following the HRA self-financing settlement, HRA debt will increase from £65m to £256.6m with a borrowing cap of £303.3m. It is proposed that the HRA will make a form of MRP to pay down this debt over the 30 year business cycle on which the settlement is based.

## **8. Monitoring and Reporting on the Treasury Outturn and Prudential Indicators**

Treasury activity is monitored and reported to Senior Management on a daily and weekly basis. Monthly updates including Prudential Indicators are provided to Cabinet as part of the budget monitoring process. Additionally a six month strategy outturn report is taken to Cabinet.

The Treasury Management Strategy Statement (including Prudential Indicators and Annual Investment Strategy) for the forthcoming financial year is submitted to Cabinet prior to agreement at full Council before the start of the financial year. An early draft is provided to Audit Committee in December. Any amendments to the TMSS which are required during the year will be submitted to Cabinet for approval. In addition, Audit Committee is responsible for the yearly scrutiny of treasury management practices.

## **9. Revision to the CIPFA Treasury Management Code of Practice and Guidance Notes**

CIPFA revised the Treasury Management Code of Practice (TM Code) and associated Guidance Notes in November 2011. This revision is an update to the TM Code and Guidance Notes last published in November 2009 and approved by Council in February 2010. The TM Code has been reviewed and updated following recent developments and anticipated regulatory changes relating to the Localism Bill 2011, including housing finance reform and the introduction of the General Power of Competence. Council is required to adopt the revised Code and approve the associated Treasury Management Policy Statement.

Below are the principle changes to the code:

- The Council must explicitly state in their TMSS whether they plan to use derivative instruments to manage risks, and ensure they have the legal power to do so.
- The Council will need to make reference to their high level approach to borrowing and investment in their Treasury Management Policy Statement. (See appendix E for the revised Treasury Management Policy Statement)

- Less focus has been placed on the 'minimum credit limits' for investment counterparties, with more focus on the 'minimum acceptable credit quality.'
- New treasury indicator: Upper limits on the proportion of net debt to gross debt; to highlight where an authority may be borrowing in advance of its cash requirement.
- The Council may wish to create a new treasury indicator which considers credit risk.
- Expansion of the risk management chapter.
- New Section in the TM Code Guidance Notes on the 'Treasury Management Implications of the Housing Self-Financing Reform. (Debt and interest allocations)

## **10. Other Items**

### **Training**

CIPFA's Code of Practice requires 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.

The Council adopts a continuous performance and development programme to ensure staff are regularly appraised and any training needs addressed. Treasury staff also attend regular training sessions, seminars and workshops. These ensure their knowledge is up to date and relevant. Details of training received are maintained as part of the performance and development process.

Council members receive education regarding treasury management as part of their general finance training. Access to additional training is provided where required.

### **Investment Consultants**

The CLG's Guidance on local government investments recommend that the Investment Strategy should state:

- Whether and, if so, how the authority uses external contractors offering information, advice or assistance relating to investment and
- How the quality of any such service is controlled.

The Council has a contract in place with Arlingclose Ltd to provide a treasury advisory service, which details the agreed schedule of services. Performance is measured against the schedule of services to ensure the services being provided are in line with the agreement.

## APPENDIX A

## EXISTING PORTFOLIO PROJECTED FORWARD

	31 Mar 12 Estimate £m	31 Mar 13 Estimate £m	31 Mar 14 Estimate £m	31 Mar 15 Estimate £m
<b>External Borrowing:</b>				
Fixed Rate – PWLB	105.2	99.9	94.7	90.4
Fixed Rate – Market	40.0	38.0	37.0	33.0
Variable Rate – PWLB	12.0	10.5	9.0	7.5
Variable Rate – Market	8.0	10.0	11.0	15.0
<b>Current Borrowing</b>	<b>165.2</b>	<b>158.4</b>	<b>151.7</b>	<b>145.9</b>
New Borrowing	-	271.8	311.3	325.2
<b>Total Borrowing</b>	<b>165.2</b>	<b>430.2</b>	<b>463.0</b>	<b>471.1</b>
Existing long term liabilities	2.9	2.5	2.2	2.0
<b>Total Gross External Debt</b>	<b>168.1</b>	<b>432.7</b>	<b>465.2</b>	<b>473.1</b>
Total Investments	38.4	39.5	36.7	34.9
<b>Net Borrowing Position</b>	<b>129.7</b>	<b>393.2</b>	<b>428.5</b>	<b>438.2</b>

**Arlingclose's Economic and 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
<b>Official Bank Rate</b>													
<b>Upside risk</b>					0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
<b>Central case</b>	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
<b>Downside risk</b>													
<b>1-yr LIBID</b>													
<b>Upside risk</b>	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
<b>Central case</b>	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
<b>Downside risk</b>	-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
<b>5-yr gilt</b>													
<b>Upside risk</b>	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
<b>Central case</b>	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
<b>Downside risk</b>	-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
<b>10-yr gilt</b>													
<b>Upside risk</b>	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
<b>Central case</b>	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
<b>Downside risk</b>	-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
<b>20-yr gilt</b>													
<b>Upside risk</b>	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
<b>Central case</b>	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
<b>Downside risk</b>	-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
<b>50-yr gilt</b>													
<b>Upside risk</b>	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
<b>Central case</b>	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
<b>Downside risk</b>	-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

- 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. We think that it could be 2016 before official UK interest rates rise.
- The UK's safe haven status, the direct effect of QE and minimal prospect of an increase in policy rates are expected to keep gilt yields at their lows in the near term.
- A disorderly outcome to the Eurozone sovereign crisis remains a key economic, credit and political risk.

**Underlying Assumptions:**

- Financial market stress is expected to remain a feature of 2012. Rates within Interbank markets (where banks fund the majority of their day to day operations) have continued to climb. This dynamic was a characteristic of the 2008 banking crisis and whilst the authorities have flooded the markets with liquidity, it is still a strong indicator of market risk.
- Inflation has moderated back to 4.8% in November. CPI is expected to drop gradually back towards the 2% target as the January 2011 VAT increase, the surge in oil prices and the large energy price hikes fall out of the twelve month comparison.
- Recent data and surveys suggest that since the summer the UK economy has lost the admittedly fragile momentum. Business and consumer surveys point to continued weakness in coming months. Public spending cuts, austerity measures, credit constraints, low business and consumer confidence could result in the economy stalling (Q3 excepted, when the 2012 Olympics will provide a temporary boost) and most likely pressure the Bank of England to provide further QE.
- Faltering global growth will not be helped by the considerable uncertainty and expansion of risks presented by the crisis in the Eurozone and gridlock in the US going into an election year. The knock-on effects could in turn weigh on growth in China and emerging market countries.
- Gilt supply is expected to be higher in 2012-13 than earlier forecast by the Treasury. However, over the short-term, gilts will retain their safe-haven status as euro area contagion risks grow.
- Sizeable European bond redemptions and refinancing (Italy in particular) in the first half of 2012 remain significant challenges. Headwinds to fiscal convergence and treaty changes could intensify downgrade pressures on the AAA core nations as well as peripheral countries. The effectiveness of the European Financial Stability Fund (EFSF) may prove limited, increasing the possibility of a sovereign failure or the break-up of the euro area.

**Specified Investments**

**Specified Investments identified for use by the Council**

Specified Investments will be those that meet the criteria in the CLG Guidance, i.e. the investment

- is sterling denominated
- has a maximum maturity of 1 year
- meets the “high credit quality” as determined by the Council or is made with the UK government or is made with a local authority in England, Wales, Scotland or Northern Ireland or a parish or community council.
- the making of which is not defined as capital expenditure under section 25(1)(d) in SI 2003 No 3146 (i.e. the investment is not loan capital or share capital in a body corporate).

“Specified” Investments identified for the Council’s use are:

- Deposits in the DMO’s Debt Management Account Deposit Facility
- Deposits with UK local authorities
- Deposits with banks and building societies
- \*Certificates of deposit with banks and building societies
- \*Gilts: (bonds issued by the UK government)
- \*Bonds issued by multilateral development banks
- Treasury-Bills (T-Bills)
- Local Authority Bills
- Corporate Bonds
- Commercial Paper
- AAA-rated Money Market Funds with a Constant Net Asset Value (CNAV)
- \*Other Money Market Funds and Collective Investment Schemes– i.e. credit rated funds which meet the definition of a collective investment scheme as defined in SI 2004 No 534 and SI 2007 No 573.

\* Investments in these instruments will be on advice from the Council’s treasury advisor.

When determining the minimum acceptable credit quality the Council will not only consider the credit rating criteria below but also information on corporate developments of and market sentiment towards investment counterparties as set out in the Credit Risk indicator.

For credit rated counterparties, the minimum criteria will be the lowest equivalent long term ratings assigned by Fitch, Moody's and Standard & Poor's (where assigned).

Long term minimum: A-(Fitch); A3 (Moody's); A- (S&P)

New specified investments will be made within the following limits:

<b>Instrument</b>	<b>Country/ Domicile</b>	<b>Counterparty</b>	<b>Maximum Counterparty Limits %/£m</b>
Term Deposits	UK	DMADF, DMO	No limit
Term Deposits/Call Accounts	UK	Other UK Local Authorities	£35m per Local Authority / No total limit
Term Deposits/Call Accounts/CD's	UK	Counterparties rated at least A- Long Term (or equivalent)	15% / £20m
Term Deposits/Call Accounts/CD's	Non-UK	Counterparties rated at least A- (or equivalent) in select countries with a Sovereign Rating of at least AA+	15% / £15m
Gilts	UK	DMO	No limit
Treasury Bills	UK	DMO	No limit
Local Authority Bills	UK	Other UK Local Authorities	No limit
Bonds issued by multilateral development banks		(For example, European Investment Bank/Council of Europe, Inter American Development Bank)	40% / £50m
AAA-rated Money Market Funds	UK/Ireland/ Luxembourg domiciled	CNAV MMFs VNAV MMFs (where there is greater than 12 month history of a consistent £1 Net Asset Value)	10% / £7.5m per fund. Maximum MMF exposure 75%
Other Money Market Funds and Collective Investment Schemes	UK/Ireland/ Luxembourg domiciled	Pooled funds which meet the definition of a Collective Investment Scheme (CIS) per SI 2004 No 534 and subsequent amendments	10% / £7.5m per fund. Maximum MMF exposure 75%



Commercial Paper	UK	Counterparties rated at least A- Long Term (or equivalent	15% / £20m
Corporate Bonds	UK	Counterparties rated at least A- Long Term (or equivalent	15% / £20m

Instrument	Country/ Domicile	Counterparty	Maximum Counterparty / Group Limit £m	Maximum Counterparty / Group Limit %
Term Deposits	UK	DMADF, DMO	No limit	No Limit
Term Deposits	UK	Other UK Local Authorities	£35m per Local Authority	No Limit
Term Deposits /Call Accounts	UK	Lloyds Banking Group (Including Bank of Scotland)	20	15
Term Deposits /Call Accounts	UK	Barclays Bank Plc	20	15
Term Deposits /Call Accounts	UK	HSBC Bank Plc	20	15
Term Deposits /Call Accounts	UK	Nationwide Building Society	20	15
Term Deposits /Call Accounts	UK	RBS Group (Royal Bank of Scotland and Nat West)	20	15
Term Deposits /Call Accounts	UK	Standard Chartered Bank	20	15
Term Deposits /Call Accounts	Australia	Australia and NZ Banking Group	15	15
Term Deposits /Call Accounts	Australia	Commonwealth Bank of Australia	15	15
Term Deposits /Call Accounts	Australia	National Australia Bank Ltd (National Australia Bank Group)	15	15
Term Deposits /Call Accounts	Australia	Westpac Banking Corp	15	15
Term Deposits /Call Accounts	Canada	Bank of Montreal	15	15
Term Deposits /Call Accounts	Canada	Bank of Nova Scotia	15	15

Term Deposits /Call Accounts	Canada	Canadian Imperial Bank of Commerce	15	15
Term Deposits /Call Accounts	Canada	Royal Bank of Canada	15	15
Term Deposits /Call Accounts	Canada	Toronto-Dominion Bank	15	15
Term Deposits /Call Accounts	Finland	Nordea Bank Finland	15	15
Term Deposits /Call Accounts	France	BNP Paribas	15	15
Term Deposits /Call Accounts	France	Credit Agricole CIB (Credit Agricole Group)	15	15
Term Deposits /Call Accounts	France	Credit Agricole SA (Credit Agricole Group)	15	15
Term Deposits /Call Accounts	France	Société Générale	15	15
Term Deposits /Call Accounts	Germany	Deutsche Bank AG	15	15
Term Deposits /Call Accounts	Netherlands	ING Bank NV	15	15
Term Deposits /Call Accounts	Netherlands	Rabobank	15	15
Term Deposits /Call Accounts	Netherlands	Bank Nederlandse Gemeenten	15	15
Term Deposits /Call Accounts	Sweden	Svenska Handelsbanken	15	15
Term Deposits /Call Accounts	Switzerland	Credit Suisse	15	15
Term Deposits /Call Accounts	US	JP Morgan	15	15

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.

The above percentage limits are based on a 30 day rolling average investment balance.

Non UK Banks are restricted to a maximum exposure of 25% per country and a total overseas aggregate exposure (excluding MMFs) of 40%.

Maturity periods may be amended to less than one year to address any emerging risk concerns.

## APPENDIX D

### Non-Specified Investments determined for use by the Council

Having considered the rationale and risk associated with Non-Specified Investments, the following have been determined for the Council's use:

	In-house use	Maximum maturity	Max % of portfolio	Capital expenditure?
<ul style="list-style-type: none"> <li>▪ Deposits with banks and building societies</li> <li>▪ CDs with banks and building societies</li> </ul>	✓	5 Years	40 In Aggregate	No
<ul style="list-style-type: none"> <li>▪ Gilts</li> <li>▪ Bonds issued by multilateral development banks</li> <li>▪ Bonds issued by UK financial institutions</li> <li>▪ Sterling denominated bonds by non-UK sovereign governments</li> <li>▪ Corporate Bonds</li> </ul>	✓ (on advice from treasury advisor)	6 Years	40 In Aggregate	No
Money Market Funds and Collective Investment Schemes, which are not credit rated	✓ (on advice from treasury advisor)	5 Years	15 In Aggregate	No

In determining the period to maturity of an investment, the investment should be regarded as commencing on the date of the commitment of the investment rather than the date on which funds are paid over to the counterparty.

## **APPENDIX E**

### **TREASURY MANAGEMENT POLICY STATEMENT**

#### **INTRODUCTION AND BACKGROUND**

The Council adopts the key recommendations of CIPFA's Treasury Management in the Public Services: Code of Practice (the Code), as described in Section 5 of the Code.

Accordingly, the Council will create and maintain, as the cornerstones for effective treasury management:-

- A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities
- Suitable treasury management practices (TMPs), setting out the manner in which the Council will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

The Council (i.e. full Council) will receive reports on its treasury management policies, practices and activities including, as a minimum, an annual strategy and plan in advance of the year. Cabinet will receive a mid-year review and an annual report after its close.

The Council delegates responsibility for the implementation and monitoring of its treasury management policies and practices to Cabinet and Audit Committee and for the execution and administration of treasury management decisions to Chief Finance Officer, who will act in accordance with the organisation's policy statement and TMPs and CIPFA's Standard of Professional Practice on Treasury Management.

The Council nominates Cabinet and Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

#### **POLICIES AND OBJECTIVES OF TREASURY MANAGEMENT ACTIVITIES**

The Council defines its treasury management activities as:

"The management of the Council's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

This Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

The Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.”

The Council’s borrowing will be affordable, sustainable and prudent and consideration will be given to the management of interest rate risk and refinancing risk. The source from which the borrowing is taken and the type of borrowing should allow the Council transparency and control over its debt.

The Council’s primary objective in relation to investments remains the security of capital. The liquidity or accessibility of the Authority’s investments followed by the yield earned on investments remain important but are secondary considerations.