AGENDA ITEM: 7

NORTH WALES FIRE AND RESCUE AUTHORITY
AUDIT COMMITTEE

1 March 2010

Prudential Indicators, Treasury Management Strategy, Investment Strategy and Minimum Revenue Provision Policy

Report by Ken Finch, Treasurer

PURPOSE OF REPORT

1 To present to Members the Prudential Indicators, Treasury Management Strategy, Investment Strategy and Minimum Revenue Provision (MRP) Policy for 2010/11.

2 To provide to Members the required changes to the Financial Regulations in order to comply with the changes to the CIPFA Treasury Management Code of Practice.

INTRODUCTION

3 The draft budget for 2010/2011 was presented to Members for approval on 21 December 2009 and normally the procedure would have been to present the Prudential Indicators and Treasury Management Strategy with the report. However, CIPFA were in the process of revising the Prudential Code and the Treasury Management Code of Practice so it was considered more practical to introduce the changes with the reports at a later date.

4 This report shows the Prudential Indicators for 2010/11 to 2012/13 and outlines the strategy to be followed regarding borrowing and investing the Authority funds in the financial year 2010/2011. The report also sets out proposals for the Authority's policy on MRP for 2010/11. The papers attached set out:-

(i) a list of prudential indicators as required by the CIPFA Prudential Code for Capital Finance in Local Authorities (Appendix A),

(ii) the Treasury Management Strategy outlining the strategy to be followed regarding short and long-term borrowing for 2010/2011 in accordance with the CIPFA code of Practice on Treasury Management (Appendix B) and

(iii) the strategy to be followed regarding the investment of Fire Authority funds (Appendix C)

(iv) Minimum Revenue Provision Statement (Appendix D).

5 CIPFA have revised the Treasury Management Code of Practice and the Prudential Code and in order to comply with the changes the Authority will have to make changes to its' Financial Regulations. Appendix E outlines the proposed changes to the Financial regulations and lists the other changes to the code that have to be complied with.

RECOMMENDATIONS

6 The Audit Committee is recommended to approve each of the five key elements of these reports, and recommend these to the Fire Authority :

(i) The Prudential Indicators set out in Appendix A.

(ii) The Treasury Management Strategy for 2010/2011 set out in Appendix B.

(iii) The Investment Strategy at Appendix C.

(iv) The Minimum Revenue Provision Policy in Appendix D.

(v) The revision to the Fire Authority's Financial Regulations at Appendix E.

APPENDIX A

PRUDENTIAL INDICATORS FOR NORTH WALES FIRE AUTHORITY

1. INTRODUCTION

1.1 The Local Government Act 2003 requires the Authority to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected capital activity or introduces limits upon that activity, and reflects the outcome of the Authority's capital appraisal systems. This report updates currently approved indicators and introduces new indicators for 2012/13.

1.2 The Capital Programme for 2010/11 was approved by the Fire Authority in December 2009 and these indicators support that programme. The Authority has freedom over capital expenditure so long as it is prudent, affordable and sustainable. In order to show it is working within these limits the Audit Committee must approve, revise and monitor at least a basic range of Prudential Indicators for the forthcoming three years.

2. THE CAPITAL EXPENDITURE PLANS

2.1 The Authority's capital expenditure plans are summarised below and this forms the first of the prudential indicators to be approved by Members. All capital expenditure in the forward programme is currently unsupported and must be funded from the Authority's own resources.

2.2 However, the Government may decide to place limits on unsupported capital expenditure by introducing a long stop control on all Local Authorities plans or, in the event of an assessment by Central Government that local plans are unaffordable at a specific Authority, it may implement a local control to limit its capital expenditure plans. No such controls were implemented during 2009/10, and the situation for 2010/11 is unclear at the moment.

	2008/09Actual £'000	2009/10 Revised £'000	2010/11 Estimate £'000	2011/12 Estimate £'000	2012/13 Estimate £'000
Capital expenditure	5,707	3,603	7,621	5,193	4,000
Financed by:					
Capital receipts	-302	0	0	0	0
Capital grants	-483	0	0	0	0
Revenue	-101	0	0	0	0
Net financing need for the year	4,821	3,603	7,621	5,193	4,000

3. The Authority's Borrowing Need (the Capital Financing Requirement)

3.1 The second prudential indicator is the Authority's Capital Financing Requirement (CFR). The CFR is simply the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Authority's underlying borrowing need. The capital expenditure above which has not immediately been paid for will increase the CFR. Members are asked to approve the CFR projections as below:

	2008/09 Actual £'000	2009/10 Revised £'000	2010/11 Estimate £'000	2011/12 Estimate £'000	2012/13 Estimate £'000
Capital Financing Requirement					
CFR	10,813	14,738	17,089	23,252	26,544
Total CFR	14,738	17,089	23,252	26,544	28,416
Movement in CFR	3,925	2,351	6,163	3,292	1,872

Movement in CFR represented by					
Net financing need for the year (above)	4,821	3,603	7,621	5,193	4,000
Less MRP/VRP	-896	-1,252	-1,458	-1,901	-2,128
Movement in CFR	3,925	2,351	6,163	3,292	1,872

3.2 The Authority is required to pay off an element of the accumulated General Fund capital spend each year through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake additional voluntary payments (VRP).

3.3 The expected impact of the capital expenditure decisions above on the Authority's debt and investment position are shown in the Treasury Strategy.

4. AFFORDABILITY PRUDENTIAL INDICATORS

4.1 The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Authority's overall finances. Members are asked to approve the following indicators:

4.2 **Actual and Estimates of the ratio of financing costs to net revenue stream** – This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. The estimates of financing costs include current commitments and the proposals in this report.

	2008/09 Actual %	2009/10 Revised %	2010/11 Estimate %	2011/12 Estimate %	2012/13 Estimate %
Ratio	4.76	5.37	6.48	7.91	8.97

4.3 **Estimates of the incremental impact of capital investment decisions on the contributions from the Constituent Authorities** – This indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in the budget report compared to the Authority's existing approved commitments and current plans.

	Proposed Budget 2010/11 £'000	Proposed Budget 2011/12 £'000	Proposed Budget 2012/13 £'000
Contribution Increase	72	314	723

APPENDIX B

Treasury Management Strategy for 2010/11 -2012/13

1. Introduction

1.1 The treasury management service is an important part of the overall financial management of the Authority's affairs. The prudential indicators in Appendix A consider the affordability and impact of capital expenditure decisions, and set out the Authority's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures the Authority meets balanced budget requirement under the Local Government Finance Act 1992. There are specific treasury prudential indicators included in this strategy which require approval.

1.2 The Authority's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management – revised November 2009). The Authority adopted the CIPFA Code of Practice on Treasury Management and a Treasury Management Policy Statement on 15 December 2003. This adoption meets the requirements of the first of the Treasury Prudential Indicators. A revised code has been issued and this report incorporates the changes to the code, the details of the changes are outlined in Appendix E for approval.

1.3 The Code requires an annual strategy to be reported to the Authority outlining the expected treasury activity for the forthcoming 3 years. A further treasury report is produced after the year-end to report on actual activity for the year, and a new requirement of the revision of the Code of Practice is that there is a mid-year monitoring report.

1.4 The strategy report will cover several areas as follows:

(i) The Authority's debt and investment projections;
(ii) The Authority's estimates and limits on future debt levels;
(ii) The expected movement in interest rates;
(iii) The Authority's borrowing strategy;
(iv) The Authority's investment, counterparty and liquidity framework;
(vi) Treasury performance indicators.

2. DEBT AND INVESTMENT PROJECTIONS 2010/11 – 2012/13

2.1 The current position as at February 2010 is as follows:

Public Works Loan Board (PWLB) - £11,617,988 Fixed Rate
- £4,395,440 Variable Rate

Investments - £3,530,000

2.2 The borrowing requirement comprises the expected movement in the CFR and any maturing debt which will need to be re-financed. The table below shows this effect on the treasury position over the next three years. It also highlights the expected change in investment balances.

£'000	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
External Debt				
Debt at 1 April	15,013	17,089	23,252	26,544
Movement in CFR	2,351	6,163	3,292	1,872
Maturing Debt Replacement	4,395	6,914	2,500	4,395
Adjustment for prior years/advance borrowing	-275	0	0	0
Debt at 31 March	17,089	23,252	26,544	28,416
Annual change in debt	2,076	6,163	3,292	1,872
Investments				
Total Investments at 31 March	3,000	2,500	3,000	3,500
Investment change	+1,350	-500	+500	+500

3. LIMITS TO BORROWING ACTIVITY

3.1 Within the prudential indicators there are a number of key indicators to ensure the Authority operates its activities within well defined limits.

3.2 For the first of these the Authority needs to ensure that its total borrowing net of any investments, does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2010/11 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

	2009/10 Revised £'000	2010/11 Estimate £'000	2011/12 Estimate £'000	2012/13 Estimate £'000
Gross Borrowing	17,089	23,252	26,544	28,416
Investments	3,000	2,500	3,000	3,500
Net Borrowing	14,089	20,752	23,544	24,916
CFR	17,089	23,252	26,544	28,416

3.3 The Treasurer reports that the Authority complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the budget report.

3.4 **The Authorised Limit** – this represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the Fire Authority. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

3.5 **The Operational Boundary** – this indicator is based on the probable external debt during the course of the year; it is not a limit. Actual external debt could vary around this boundary for short times during the year. It should act as a monitoring indicator to ensure the authorised limit is not breached.

3.6 Members are asked to approve the following authorised limit and operational boundary:

	2009/10 Revised £'000	2010/11 Estimate £'000	2011/12 Estimate £'000	2012/13 Estimate £'000
Authorised Limit	19,089	25,252	28,544	30,416
Operational Boundary	17,089	23,252	26,544	28,416

4. EXPECTED MOVEMENT IN INTEREST RATES

4.1 Short-term rates are expected to remain on hold for a considerable time. The recovery in the economy has commenced but it will remain insipid and there is a danger that early reversal of monetary ease, (rate cuts and Quantative Easing {QE}), could trigger a dip back to negative growth and a W-shaped GDP path.

4.2 The main drag upon the economy is expected to be weak consumers' expenditure growth. The combination of the desire to reduce the level of personal debt and job uncertainty is likely to weigh heavily upon spending. This will be amplified by the prospective increases in taxation already scheduled for 2010 – VAT and National Insurance. Without a rebound in this key element of UK GDP growth, any recovery in the economy is set to be weak and protracted.

4.3 With inflation set to remain subdued in the next few years (though a sharp blip is forecast for the next few months), the pressure upon the MPC to hike rates will remain moderate. But some increase will be seen as necessary in 2010 to counter the effects of external cost pressures (as commodity price strength filters through) and to avoid damage that sterling could endure if the UK is seen to defy an international move to commence policy exit strategies.

4.4 Longer term rates are expected to be more volatile. The current 'softness' of gilt yields & PWLB rates may continue for a while yet, given that these are being driven by a benign international backdrop and the effects of QE. Nevertheless this process will come to an end before the close of the financial year. This is likely to herald a return to rising yields for a number of reasons:

- Net gilt issuance will rise sharply;
- This will be increased by the extent to which the B of E attempts to

claw back funds injected to the economy via the QE programme;
- Investors will be looking to place more of their funds in alternative instruments as their risk appetite increases, demand for gilts will weaken as a consequence;
- A decision to leave QE in place will generate inflation concerns and pressurise long yields higher.

Medium-Term Rate Estimates (averages)

Annual Average %	Bank Rate	Money Rates		PWLB Rates*		
		3 mth	1 year	5 year	20 year	50 year
2008/09	3.9	5.0	5.3	4.2	4.8	4.5
2009/10	0.5	0.8	1.4	3.2	4.4	4.6
2010/11	1.0	1.5	2.3	4.0	5.0	5.2
2011/12	2.0	2.5	3.3	4.3	5.3	5.3
2012/13	4.5	4.8	5.3	5.3	5.5	5.3

* Borrowing

5. BORROWING STRATEGY 2010/11 – 2012/13

5.1 The uncertainty over future interest rates increases the risks associated with treasury activity. As a result the Authority will take a cautious approach to its treasury strategy.

5.2 Long-term fixed interest rates are at risk of being higher over the medium term, and short term rates are expected to rise, although more modestly. The Treasurer, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above. It is likely that shorter term fixed rates may provide lower cost opportunities in the short/medium term.

5.3 With the likelihood of long term rates increasing, debt restructuring is likely to focus on switching from longer term fixed rates to cheaper shorter term debt, although the Treasurer and treasury consultants will monitor prevailing rates for any opportunities during the year.

5.4 The option of postponing borrowing and running down investment balances will also be considered. This would reduce counterparty risk and hedge against the expected fall in investments returns.

6. INVESTMENT, COUNTERPARTY AND LIQUIDITY FRAMEWORK

6.1 All investments will be made as cash deposits to banks, building societies and local authorities. Some loans will be made through one of several broking firms who are used by Conwy and others will be direct with the institution. The majority of investments will be no longer than 364 days and will be made according to the latest market forecasts.

6.2 The Treasurer will maintain a counterparty list in compliance with the following criteria:-

Banks £5m limit
All UK and Irish banks and their subsidiaries that have good ratings (Fitch or equivalent). This is currently defined as

short term	F1
long term	A
Individual/financial Strength	B
Support	3

Banks whose ratings fall below those in the table above will be used if wholesale deposits are covered by a government guarantee.

Central Government £5m limit
Debt management Office

Local Authorities £2m limit
All except those subject to limitation of Authority tax and precepts under Part 1 of the Local Government Finance Act 1992.

Building Societies £2m limit
Building societies with a rating (as for the banking sector).

Building Societies (Assets £1bn) -£2m /9mths limit
Building societies without a rating but with assets of £1billion or more.

6.3 The criteria set out above for choosing counterparties provide a sound approach to investment and are designed to reduce the financial risks to the Authority of investing money on the money market. The position of the above counterparties are monitored closely and treasury staff will adjust activities at short notice to protect the Authority's position.

7. TREASURY PERFORMANCE INDICATORS

7.1 There are three treasury prudential indicators the purpose of which is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs.

7.2 It is recommended that the Authority sets upper and lower limits for the maturity structure of its fixed rate borrowings as follows:

	Upper Limit	Lower Limit
Under 12 Months	40%	0%
12 Months and within 24 Months	40%	0%
24 Months and within 5yrs	50%	0%

5 yrs and within 10 yrs	75%	0%
10 yrs and above	100%	0%

7.3 It is recommended that the Authority approve the following limits on Fixed and Variable interest rates.

	% Borrowing
Fixed Interest Rate	55 – 100
Variable Interest Rate	0 – 45

Appendix C

INVESTMENT STRATEGY

1. CURRENT OUTLOOK

1.1 **Key Objectives** - The Authority's investment strategy primary objectives are safeguarding the re-payment of the principal and interest of its investments on time first and ensuring adequate liquidity second – the investment return being a third objective. The current investment climate has one over-riding risk consideration, that of counterparty security risk. As a result of these underlying concerns officers are implementing an operational investment strategy which tightens the controls already in place in the approved investment strategy.

1.1 Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of the current 0.5% Base rate remaining into mid 2010, with small increases thereafter leaving the rate at 2%by the end of 2011/12.The Authority's investment decisions are based on comparisons between the rises priced into market rates against the Authority's and advisers own forecasts.

1.2 There is a clear operational difficulty arising from the current banking crisis. Ideally investments would be invested longer to secure better returns, however uncertainty over counterparty creditworthiness suggests shorter dated would provide better security.

2. NATIONAL ASSEMBLY FOR WALES INVESTMENT GUIDANCE

2.1 The National Assembly for Wales issued Investment Guidance in March 2004, and this forms the structure of the Authority's policy below.

2.2 The key intention of the Guidance is to maintain the current requirement for Authorities to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective, the guidance requires this Authority to have regard to the CIPFA publication "Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes". This Authority adopted the Code on 15 December 2003 and will apply its principles to all investment activity. In accordance with the Code, the Treasurer has produced its treasury management practices. TMP 1(5), covering investment counterparty policy requires approval each year.

2.3 Annual Investment Strategy - Approved Instruments

The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of following:

- (i) The strategy guidelines for decision making on investments, particularly non-specified investments.
- (ii) The principles to be used to determine the maximum periods for

which funds can be committed.

(iii) Specified investments the Authority will use. These are high security and high liquidity investments in sterling and with a maturity of no more than a year.

(iv) Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

2.4 The investment policy proposed for the Authority is:

(i) Strategy Guidelines – The main strategy guidelines are outlined above with the emphasis on security and liquidity.

(ii) Investment Periods – The Authority's policy is to lend funds for a maximum of 364 days.

(iii) Specified Investments – These investments are sterling investments of not more than one-year maturity. These are low risk assets where the possibility of loss of principal or investment income is small. These would include investments with the:

The Treasury Debt Management Office
Other Local Authorities (except rate capped)
All UK and Irish Banks and Building Societies with a high credit rating

(iv) Non-Specified Investments – Non-specified investments are any other type of investment (i.e. not defined as Specified above). This includes Building Societies with no rating and lending for more than 364 days. The limit for "non-specified" investments had been set at £4m.

APPENDIX D

Minimum Revenue Provision Statement

Background

1. The Capital Financing Requirement (CFR) is simply the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources and is essentially a measure of the Authority's underlying borrowing need. The Authority is required to pay off an element of the accumulated capital spend each year through a charge to the revenue account (the MRP) although it is also allowed to undertake additional voluntary payments.

2. Regulations have been issued which require the Fire Authority to approve an MRP statement in advance of each year.

MRP Policy

3. Members are recommended to approve the following MRP policy:

   For capital expenditure incurred before 1 April 2010 and any subsequent expenditure the MRP policy will be to repay
   - 4% of the outstanding balance of capital expenditure incurred on Land & Buildings
   - and for Vehicles, Plant, Equipment and Infrastructure the MRP will be based on the estimated life of the assets.

4. The above policy is in line with the Regulations and also follows the practice operated by the Fire Authority for a number of years. The budget for 2010/11 approved by Members in December 2009 was set using the above practices.

APPENDIX E

PRUDENTIAL CODE AND TREASURY MANAGEMENT CODE OF PRACTICE CHANGES

1. SUMMARY OF CHANGES

1.1 Prudential Code:

- Movement of the TM Prudential Indicators to the TM Code of Practice
- Emphasis on security and liquidity
- No borrowing to on-lend

1.2 TM Code of Practice:

- final decision for TM activity lies with the Authority
- nomination of a responsible body for ensuring effective scrutiny of strategy and policies
- requirement of a mid-year monitoring report
- adequate Members and officers TM training
- tighter controls on counterparty monitoring

2. TREASURY MANAGEMENT CLAUSES TO FORM PART OF FINANCIAL REGULATIONS

2.1 This Authority 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 TMPs, setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

2.2 The Authority 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, a mid year review and an annual report after its close, in the form prescribed in its TMPs.

2.3 The Authority delegates responsibility for the execution and administration of treasury management decisions to the Treasurer, who will act in accordance with the Authority's policy statement and TMPs and CIPFA's Standard of Professional Practice on Treasury Management.

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