

**Joint Report of the Chief Executive and Chief Constable to the Chair
and Members of Police Authority Executive
25th February 2010**

**Executive & Presenting Officer: Joe McCarthy Chief Executive
Mrs Ann Hall, Assistant Chief Officer
(Finance & Commissioning)**

Status: For Decision

Treasury Management and Prudential Indicators

1 Executive Summary

Following the collapse of the Icelandic Banks, treasury management in public sector organisations continues to receive a significant amount of focus and emphasis. Two national reports were published, the Audit Commission's "Risk and Return" on local authority treasury management and the Communities and Local Government Select Committee's Review of local authority investments.

Attached to this report, for Members information, is a Treasury Management Bulletin from CIPFA that provides an update on the work that has taken place to December 2009 and that planned for the future in relation to Treasury Management.

Whilst this report constitutes advice only and does not have legislative powers the contents are a very useful guide to areas for potential development in relation to Treasury Management for the Force and Authority.

2 Purpose

- 2.1 This report is one of a set of six that are on today's agenda for consideration by Members:
- Robustness of Estimates & Adequacy of Financial Reserves
 - Prudential Indicators & Treasury Management Strategy 2010/14
 - Minimum Revenue Provision Strategy 2010/11
 - 2010/11 Budget and LTFP 2011/15
 - 2010/11 Capital Programme & Outline Capital Plan 2011/14

- Setting the 2010/11 Precept
- 2.2 These reports are part of the process introduced by the Authority to establish sustainable annual and long term financial plans and maintain prudent financial management.
- 2.3 To comply with the CIPFA Prudential Code of Practice Members are required to set a range of Prudential Indicators for the financial year 2010/11.
- 2.4 The code states that prudential indicators for treasury management should be considered together with the annual investment strategy for 2010/11.

3 Recommendations

Members are asked to:

- 3.1 Approve the Prudential Indicators, set out in 4.5, 4.6 and 4.7.
- 3.2 Note that the authority delegated to the Chief Executive in consultation with the Deputy Section 151 officer to amend the approved list of counterparties and the investment limits with institutions will cease as at 31st March 2010 and future investments will be placed in line with the strategy in Appendix A.
- 3.3 Approve that if at any stage the turbulence in the financial markets is judged to have returned that the delegated authority referenced in 3.2 is immediately put back in place following consultation with the Chair of the Policy and Resources Panel.
- 3.4 Formally approve that Middlesbrough Council continue to act as an agent on behalf of Cleveland Police Authority in relation to placing and committing the Authority to Investments within the constraints of our Investment Strategy.
- 3.5 Approve the Annual Investment Strategy set out at Appendix A.

4 Reasons

4.1 Prudential Indicators

The Prudential Code requires authorities to self regulate the affordability, prudence and sustainability of their capital expenditure and borrowing plans, by setting estimates and limits, and by publishing actuals, for a range of prudential indicators. It also requires them to ensure their Treasury Management Practices are in accordance with good practice.

- 4.2 The Code imposes on Authorities clear governance procedures for setting and revising of prudential indicators, and describes the matters to which an authority will have regard when doing so. This is designed to deliver

accountability in taking capital financing, borrowing and treasury management decisions. A fundamental provision of the Prudential Code is that over the medium term net borrowing will only be for a capital purpose.

4.3 Under the Code, individual authorities are responsible for deciding the level of their affordable borrowing, having regard to the code. Under the code Members are required to set a range of Prudential Indicators for the financial year 2010/11.

4.4 The code states that prudential indicators for treasury management should be considered together with the annual Investment Strategy.

4.5 Affordability

The following indicators are required to assess the affordability of our capital investment plans. They provide an indication of the impact of the capital investment plans on overall Authority finances. Members are requested to approve the following:

4.5.1 Ratio of Financing Costs to Net Revenue Stream

This indicator identifies the trend in the cost of capital against the net budgetary requirement. In 2008/9 the actual cost in this area totalled £115k. It is expected to have increased to £1,057k during 2009/10 as a result of lower cash balances and lower interest rates being achieved on investments coupled with increasing levels of borrowing. This significant increase is expected to continue throughout the life of the current Revenue and Capital Plans as a result on increasing levels of borrowing and investment in the asset base of the Force and Authority. We are expecting during 2010/11 that 1% of our funding will be used to service our borrowing, this is forecast to increase to 1.4% across the life of the plan but this could be significantly higher if reduction in our funding levels materialise as expected.

Financing Costs to Net Revenue Streams	2010/11	2011/12	2012/13	2013/14
	Estimate	Estimate	Estimate	Estimate
	£000	£000	£000	£000
Minimum Revenue Provision (MRP)	771	979	1,023	1,077
Interest Payable on Borrowing	671	906	949	999
Interest Receivable	(100)	(250)	(250)	(250)
Financing Costs	1,342	1,635	1,722	1,825
Net Revenue Stream	132,172	132,172	132,172	132,172
Ratio %	1.0%	1.2%	1.3%	1.4%

Whilst the current projections are provided for in the Long Term Financial Plan, serious consideration should be given to any proposed increases in borrowing. The Force and Authority should seriously consider alternative ways of funding future capital expenditure that does not involve increased levels of borrowing.

4.5.2 Incremental Impact of Capital Investment Decisions on Band D Council Tax

This indicator shows the incremental impact of the additional capital expenditure that is planned in the current programme on the Band D council tax.

Council Tax	2010/11	2011/12	2012/13	2013/14
	Estimate	Estimate	Estimate	Estimate
	£	£	£	£
Band D Impact	1.37	0.94	0.28	0.33

Subject to Members approving a 2.94% increase in Precept for 2010/11, the level of Council Tax for a Band D property, will increase by £5.37. As can be seen from the above, £1.37 (or 26%) of this is as a result of the impact of Capital Investment decisions.

4.6 Prudence

The table below summarises the capital programme that is also on today's agenda for approval.

Capital Expenditure	2010/11	2011/12	2012/13	2013/14
	Estimate	Estimate	Estimate	Estimate
	£000	£000	£000	£000
Total Capital Expenditure	10,209	3,673	4,235	2,473
Funded By:				
Gross Borrowing	5,972	2,072	2,372	872
Other Capital Resources	4,237	1,601	1,863	1,601
%age of Expenditure funded by Borrowing	58.5%	56.4%	56.0%	35.3%

Members' attention is brought to the final line of the above table and the significant proportion of the Capital Programme that will be funded by borrowing in the following years.

4.6.1 The Authority's Borrowing Need (The Capital Financing Requirement)

The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for Capital purposes and ensures that borrowing is only undertaken to fund capital assets and not support revenue expenditure.

Members are asked to approve the following CFR projections:

Capital Financing Requirement	2010/11	2011/12	2012/13	2013/14
	Estimate	Estimate	Estimate	Estimate
	£000	£000	£000	£000
Opening Capital Financing Requirement	21,269	26,470	27,564	28,913
Borrowing to fund Capital Expenditure	5,972	2,072	2,372	872
Less: MRP	(771)	(979)	(1,023)	(1,077)
Closing Capital Financing Requirement	26,470	27,564	28,913	28,708

The Gross Borrowing requirement detailed in the table 3.5 above increases the CFR. The Authority is required to make a statutory charge to revenue for the

repayment of debt (the Minimum Revenue Provision) this reduces the CFR. Members are asked to note the projected CFR at the end of 2010/11 of £26,470k is £10,623k (or 67%) higher than the £15,847k that it was in 2006/7.

4.6.2 *Limits to Borrowing Activity*

Within the Prudential indicators there are a number of indicators to ensure that the Authority operates its activities within well defined limits.

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, to take advantage of market opportunities and to build in budget uncertainty.

Net Borrowing and the Capital Financing Requirement (CFR)	2010/11	2011/12	2012/13	2013/14
	Estimate	Estimate	Estimate	Estimate
	£000	£000	£000	£000
Borrowing	19,998	21,685	22,376	23,248
Investments	(8,500)	(8,500)	(8,500)	(8,500)
Net Borrowing	11,498	13,185	13,876	14,748
CFR	26,470	27,564	28,913	28,708

The projected forecasts detailed in the table above show that whilst our net borrowing is increasing there is still some margin between this and the CFR and therefore the Authority will be well within the limits required.

4.6.3 A further two prudential indicators control or anticipate the overall level of borrowing. These are:

- The **Authorised Limit** which represents the limit beyond which borrowing is prohibited and needs to be set and revised by Members, borrowing beyond this limit would be ultra vires.
- The **Operational Boundary** which is based on the probable external debt during the course of the year. It includes scope for borrowing for revenue purposes that may be required in the short term during the year, if for instance a large grant payment was delayed.

Members are asked to approve the following limits:

Authorised Limit for External Debt	2010/11	2011/12	2012/13	2013/14
	Estimate	Estimate	Estimate	Estimate
	£000	£000	£000	£000
Borrowing	19,998	21,685	22,376	23,248
Provision for Temporary Borrowing	4,000	4,000	4,000	4,000
	23,998	25,685	26,376	27,248

Operational Boundary for External Debt	2010/11	2011/12	2012/13	2013/14
	Estimate	Estimate	Estimate	Estimate
	£000	£000	£000	£000
Borrowing	19,998	21,685	22,376	23,248
Provision for Temporary Borrowing	2,000	2,000	2,000	2,000
	21,998	23,685	24,376	25,248

4.7 Treasury Management Indicators

The purpose of these is to contain the activity of the treasury function within certain limits, thereby reducing the risk or likelihood of an adverse movement in interest rates or borrowing decisions impacting negatively on the Authority's overall financial position. Members are asked to approve the indicators below:

4.7.1 Upper Limits on Borrowing

This indicator identifies a maximum level of borrowing that can be made at Fixed and Variable interest rates.

Borrowing	2010/11	2011/12	2012/13	2013/14
	Estimate	Estimate	Estimate	Estimate
	%	%	%	%
Upper Limit on Fixed Interest Rate Exposures	100	100	100	100
Upper Limit of Variable Rate Exposures	20	20	20	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 so liable to change at short notice.

The Authority has not entered into any variable rate loans previously and there is no intention to do so in the future. However, the indicator provides some flexibility should the need ever arise.

4.7.2 Upper Limits on Investments

This indicator identifies a maximum level of investments that can be made at Fixed and Variable interest rates.

Investments	2010/11	2011/12	2012/13	2013/14
	Estimate	Estimate	Estimate	Estimate
	%	%	%	%
Upper Limit on Fixed Interest Rate Exposures	100	100	100	100
Upper Limit of Variable Rate Exposures	20	20	20	20

This means 80%-100% of our investments will be at rates fixed until the investment matures, while no more than 20% will be at variable rates so liable to change at short notice.

The Authority has not entered into any variable rate investments previously and there is no intention to do so in the future. However, the indicator provides some flexibility should the need ever arise.

4.7.3 Maturity Structure of Debt

These gross limits are set to reduce the Authority's exposure to large fixed rate sums falling due for re-financing within a short timeframe. Upper and lower limits are required which Members are asked to approve.

Maturity Structure of Debt	2010/11		2011/12		2012/13		2013/14	
	Lower	Upper	Lower	Upper	Lower	Upper	Lower	Upper
Under 12 months	0%	50%	0%	50%	0%	50%	0%	50%
Over 12 months and under 2 years	0%	50%	0%	50%	0%	50%	0%	50%
Over 2 years and under 5 years	0%	50%	0%	50%	0%	50%	0%	50%
Over 5 years and under 10 years	0%	50%	0%	50%	0%	50%	0%	50%
Over 10 years	0%	100%	0%	100%	0%	100%	0%	100%

4.7.4 Upper Limit for Sums Invested for a Period of over 364 days

Principal Sums Invested > 1yr	2010/11	2011/12	2012/13	2013/14
	Estimate	Estimate	Estimate	Estimate
	£000	£000	£000	£000
Maturity Profile	2,000	2,000	2,000	2,000

This indicator sets a limit on the level of investments that can be made for more than 364 days. Members are asked to approve that we do not invest more than £2m for a period of greater than 1 year.

4.8 Annual Investment Strategy

The proposed Annual Investment Strategy for 2010/2011 is attached at Appendix A. This includes the criteria for inclusion on the Counterparty List and also how this is split between Specified and Non-specified Counterparties.

4.9 Members will recall that from the 30th September 2008 authority has been delegated to the Chief Executive in consultation with the Deputy Section 151 officer to amend the approved list of counterparties and the investment limits with institutions. Due to there being less turbulence in the financial markets this delegated authority will cease as at 31st March 2010 and future investments will be placed in line with the strategy in Appendix A.

4.10 Members are asked to approve that if at any stage the turbulence in the financial markets is judged to have returned that the delegated authority referenced in 4.9 is immediately put back in place. The Chair of the Policy and Resources Panel will be consulted in relation to this decision and Members will be informed of the rationale for doing so and the decisions made at the first opportunity.

4.11 Approval for Middlesbrough Council to place Investments

Middlesbrough Council advises Cleveland Police Authority on Treasury Management and invests surplus funds on our behalf on an agency basis. We calculate the available balance, select the investment period and determine,

where appropriate, a 'target' rate. These investments are made subject to our Investment Strategy and can only be made by an officer of Middlesbrough Council who has the authority to deal on their behalf.

4.12 Members are asked to formally approve that Middlesbrough Council continue to undertake the above role in 2010/11.

4.13 Middlesbrough Council will also be requested to notify the Authority of changes to their Counterparty list within one hour of agreeing the change.

4.14 Returns on Investments

While returns on investments are of secondary importance to the security of the sums invested, it is still important to consider the potential impact of approving the Investment Strategy put forward. The limited number of counterparties on our list potentially restricts the returns, in the form of interest receivable, which the Authority can make.

4.15 Given the current low level of interest rates, the Bank of England Base rate is currently 0.5%, the impact will be relatively small. We will expect to invest our surplus cash balances at 0.3% above the base rate throughout the year which we expect to be a very competitive rate given the short length of time we will be investing most of our balances for. If we were to forego an additional 0.2%, in terms of interest rates achieved on our investments, as a result of the strategy we have put in place, this would translate into a reduction in interest receivable across the whole of 2010/11 of £20k and reality I would expect that it would be even less than this.

4.16 Counterparty Limits

Previous years' investment strategies have limited the amounts to be invested with counterparties, whether these are specified or non-specified counterparties as follows:

- The maximum investment with any counterparty is £3 million.
- The maximum investment in any one group (i.e. a bank and its wholly-owned subsidiaries) is £5 million.

As Members will note from the investment strategy attached at Appendix A these limits have been increased. The rationale for doing so, in arguably more uncertain financial times, is that we have significantly reduced the counterparties that we will choose to invest our surplus funds with, to reduce the risk in this area. We therefore need to increase the limits for those that we have chosen to use to ensure that we have sufficient scope within these counterparties to invest the cash that we will have during 2010/11.

5 Implications

5.1 Finance

There are no financial implications arising from this report which are not included above.

5.2 Diversity & Equal Opportunities

Diversity considerations are kept under constant review in line with Force policies and 'Putting People First'. There are no issues arising from this report to bring to Members attention.

5.3 Sustainability

This report is part of the process introduced by the Authority to establish sustainable annual and medium term financial plans and maintain prudent financial management.

5.4 Risk

The collapse of the Icelandic Banks highlighted a real risk to the public sector of their Treasury Management decisions and emphasised the importance of the security of the investment before the return on those investments. While this risk cannot be mitigated totally it is important for those risks to be addressed, understood and minimised. The investment strategy put forward today seeks to minimise the risks of the Authority while ensuring that the cash balances of the Authority are managed in line with proper practice and to ensure funds are available to make payments at the correct time.

6 Conclusions

6.1 To comply with the CIPFA Prudential Code of Practice Members are required to set a range of Prudential Indicators for the financial year 2010/11.

6.2 The CIPFA code does not set benchmark indicators. Each organisation must use its judgement when setting indicators.

6.3 Based on the indicators proposed above, the revenue budget, capital programme and associated financing are within prudent limits.

6.4 A prudent Investment Strategy has been put forward for approval that seeks to firstly secure the money being invested before secondly looking at rates of return. As such a significantly reduced counterparty list has been produced, in comparison to previous years, but the limits for Specified Investments have been increased from previous years as we seek to place with majority of our investments with these counterparties.

Joe McCarthy
Chief Executive

Sean Price
Chief Constable

Annual Investment Strategy

Cleveland Police Authority's strategy has regard to the Office of the Deputy Prime Minister's (ODPM'S) Guidance on Local Government Investments issued in March 2004 and CIPFA's Treasury Management in Public Services Fully Revised Third Edition 2009 (A copy of which will be made available in the Members Library) and Cross Sectoral Guidance Notes.

The main investment priorities are:

- The security of capital; and
- The liquidity of its investments.

Cleveland Police Authority also aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

The borrowing of monies purely to invest or on-lend and make a return is not lawful and Cleveland Police Authority will not engage in such activity.

The ODPM guidance on Local Government Investments sets out a range of investments which can be used and these are listed as either "specified" or "non-specified" investment categories.

In practice it is not intended that Cleveland Police Authority should depart significantly from the existing procedures, which have proven to be robust.

The guidance recognises that there has been much debate about the reliance placed by local authorities on counter-parties' credit ratings. Credit ratings are an important source of information but it is important to realise that they do have limitations. Authorities are advised to have regard to the ratings issued by the three main agencies and to make their decisions on the basis of the lowest rating. Ratings should be kept under review and 'ratings watch' notices acted upon.

Credit ratings should not be relied upon in isolation to identify counterparties, but should be considered along side generally available market information. Other sources of information should be reviewed by authorities. These include the quality financial press, market data, information on government support for banks and the credit ratings of that government support.

An authority should define what it means by a high or strong credit rating in order that its treasury management strategy is clear and its approach to risk is transparent.

Although the guidance definition of Non-Specified Investments is "one not meeting the definition of a Specified Investment", the Authority is required to identify which categories of investments are identified as prudent to use and the limits on any such investment either individually or in total. It is because some organisations do not subscribe to credit rating agencies that they have to be included as Non-Specified Investments, rather than any concern over their creditworthiness.

Limits and Definition of Specified Investments

- (a) The investment is made with the UK Government or a Local Authority (as defined in the Local Government Act 2003).
- (b) The investment is made with a Money Market Fund which, at the time the investment is made, has been awarded the highest credit rating, (AAA), by a credit rating agency.
- (c) The investment is made with the Authority's own bank, currently NatWest.
- (d) The investment is made with a Nationalised Bank or Building Society
- (e) The investment is made with a Bank or Building Society that is part owned by the UK Government.

Where officers become aware of a revision of a body's rating the body should be removed from the list of Specified Investments. The Authority currently has no method of knowing about changes in ratings and has organised the Specified and Non-Specified split to avoid subscribing to one of the companies supplying monthly ratings, which would be expensive.

All Specified Investments must be denominated in sterling and must be one where the Authority may require it to be repaid or redeemed within 12 months of the date on which the investment is made. The investment must not constitute the acquisition of share capital or loan capital in any body corporate.

- The minimum % of the total of all investments which must be Specified Investments, at the time the investment is made, is 5%.
- The maximum investment with any one counterparty is £7 million.
- The maximum investment in any one group (i.e. a bank and its wholly-owned subsidiaries) is £10 million.

Limits and Definition of Non-Specified Investments

The investment is made with one of the bodies listed in Appendix B "Non Specified Investments", or the investment is for a period of one year or longer.

All Non-Specified Investments must be denominated in sterling. The investment must not constitute the acquisition of share capital or loan capital in any body corporate.

- The maximum investment with any one counterparty is £5 million.
- The maximum investment in any one group (i.e. a bank and its wholly-owned subsidiaries) is £7 million
- The maximum % of the total of all investments for a period of one year or longer, at the time the investment is made, is 10%.

Criteria for Inclusion on Investment Counterparty List

- UK Clearing Banks and their wholly owned subsidiaries. Nationalised Banks and Nationalised Building Societies.
- UK Local Authorities, Police Authorities and nationalised industries.
- The UK Government.

Counterparty List

Specified Investments:

UK Government

Local and Police Authorities

AAA – rated Money Market Funds

NatWest Bank (The Police Authority's own bank)

Nationalised Banks/Building Societies

1. Northern Rock

2. Bradford and Bingley

Banks Part Owned by the UK Government

1. Lloyds Banking Group

2. Royal Bank of Scotland

Unspecified Investments:

▪ UK Clearing Banks (Not included elsewhere on the Investment List)

1. Abbey

2. Alliance and Leicester

3. Bank of England

4. Barclays

5. Clydesdale

6. The Co-operative Bank

7. HSBC

8. Nationwide