REPORT TO: **THE MORAY COUNCIL ON 11TH FEBRUARY 2010**

SUBJECT: **CAPITAL INVESTMENT AND TREASURY MANAGEMENT PERFORMANCE INDICATORS**

BY: **CHIEF FINANCIAL OFFICER**

1. REASON FOR REPORT

1.1 The purpose of this report is to ask Members to approve the indicators which will be used to measure the Council's performance in Capital Investment decisions.

1.2 This report is submitted to the Council in terms of Section II (2) of the Council's Administrative Scheme relating to approval of annual estimates for revenue and capital.

2. RECOMMENDATION

2.1 The Council is recommended to:

(1) Adopt the Prudential Indicators and Limits for 2010/11 to 2012/13 contained in the report.

(2) Approve the Treasury Management Strategy for 2010/11 and the Treasury Prudential Indicators for 2010/11 to 2012/13.

3. BACKGROUND

3.1 The Local Government (Scotland) Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected activity or sets limits upon the activity, and reflects the outcome of the Council's underlying capital appraisal systems.

3.2 This report revises the indicators for 2009/10, 2010/11 and 2011/12 and introduces new indicators for 2012/13. The indicators are based on the proposed budgets for 2010/11 (both capital and revenue) and the indicative budgets for 2011/12 and 2012/13.

3.3 Within this overall prudential framework there is a clear impact on the Council's treasury management activity, either through borrowing or investment activity. As a consequence the treasury management strategy for 2010/11 is also included in this report together with the prudential indicators relating to the treasury activity.

3.4 Actual outturn figures for 2008/09 have previously been circulated to Members in August 2009. These figures have been included in the report for comparison purposes.

4. PERFORMANCE INDICATORS

4.1 The Capital Expenditure Plans

The Council's capital expenditure plans are summarised below and this forms the first of the prudential indicators. Part of this expenditure is paid for immediately (by resources such as capital receipts, capital grants etc.), and the residual expenditure forms a borrowing need.

A certain level of capital expenditure will be grant supported by the Scottish Government; anything above this level will be unsupported and will need to be paid for from the Council's own resources.

4.1.1 The Council is asked to approve the summary capital expenditure projections below. This forms the first prudential indicator:

	2008/09 Actual	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
	£'000	£'000	£'000	£'000	£'000
Capital Expenditure					
Non-HRA	29,982	32,053	37,353	47,420	44,825
HRA	6,498	3,610	9,047	9,721	16,352
Financed by:					
Capital receipts	4,436	2,034	2,409	3,261	1,364
Capital grants	15,886	24,089	20,320	32,800	35,300
Reserves	2,735	-	-	625	-
Revenue	799	1,090	2,064	1,000	1,800
Net financing need for the year	**12,624**	**8,450**	**22,007**	**12,555**	**21,713**

The reduction in financing need between 2008/09 and 2009/10 and between 2010/11 and 2011/12 is because of the timing of the receipt of flood grant. The Capital Grant for 2011/12 and beyond has yet to be announced by the Scottish Government. The grant level assured in the table assumes that the Government will contribute 80% towards the capital cost of Flood Alleviation Schemes included in the Council's Capital plan. This funding is by no means certain and as a worst case scenario could result in no grant funding being made available for the Flood Alleviation Schemes beyond 2010/11.

The Council's Borrowing Need (the Capital Financing Requirement)

4.2 The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is the total outstanding capital expenditure which has not yet been paid for from either revenue or capital resources (grants or capital receipts). It is essentially a measure of the Council's underlying borrowing need.

The Council pays off an element of the accumulated debt each year through a revenue charge (the scheduled debt amortisation).

4.2.1 The Council is asked to approve the CFR projections below:

	2008/09 Actual	**2009/10 Revised**	**2010/11 Estimated**	**2011/12 Estimated**	**2012/13 Estimated**
	£'000	£'000	£'000	£'000	£'000
CFR – Non Housing	121,383	122,070	132,774	136,835	140,347
CFR – Housing	37,728	38,330	42,182	42,955	53,030
Total CFR	**159,111**	**160,400**	**174,955**	**179,790**	**193,377**
Movement in CFR	**5,218**	**1,289**	**14,555**	**4,834**	**13,587**

Net financing need for the year (above)	12,624	8,450	22,007	12,555	21,713
Scheduled debt amortisation	(7,406)	(7,161)	(7,452)	(7,721)	(8,126)
Movement in CFR	**5,218**	**1,289**	**14,555**	**4,834**	**13,587**

4.3 Limits to Borrowing Activity

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

4.3.2 For the first of these the Council 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 2009/10 and the next two financial years. This allows some flexibility for limited early borrowing for future years.

	2008/09 Actual	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
	£'000	£'000	£'000	£'000	£'000
Gross Borrowing	138,171	139,460	154,015	158,850	172,437
Investments	7,950	1,628	28	28	28
Net Borrowing	130,221	137,832	153,987	158,822	172,409
CFR	159,111	160,400	174,955	179,790	193,377

Investments are anticipated to decrease from £7.95M at 31 March 2009 to £1.7M at 31 March 2010 in line with the Council's strategy to reduce exposure to credit risk in the investment market.

4.3.3 The Council has 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 this budget report.

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

The Authorised Limit for External Debt – This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the Council. 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 the Local Government (Scotland) Act 2003.

The Operational Boundary for External Debt – This indicator is based on the expected maximum external debt during the course of the year; it is not a limit.

4.3.5 The Council is asked to approve the following Authorised Limit and Operational Boundary:

Authorised limit	2008/09 Actual	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
	£'000	£'000	£'000	£'000	£'000
Borrowing	138,171	145,267	187,274	199,829	221,542
Operational Boundary	**2008/09 Actual**	**2009/10 Revised**	**2010/11 Estimated**	**2011/12 Estimated**	**2012/13 Estimated**
	£'000	£'000	£'000	£'000	£'000
Borrowing	138,171	140,267	177,274	189,829	211,542

4.4 Affordability Prudential Indicators

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

4.4.2 **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.

%	2008/09 Actual	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
Non-HRA	6.37%	5.75%	5.95%	6.12%	6.20%
HRA	17.02%	13.86%	13.84%	14.28%	15.85%

The estimates for financing costs include current commitments and the proposals in the Financial Plan Review.

The percentage reduction between 2008/09 and 2009/10 reflects the reduced cost of advances to borrowing accounts.

4.4.3 **Estimates of the incremental impact of capital investment decisions on the Council Tax** – This indicator identifies the revenue costs associated with ***new schemes*** introduced to the capital programme recommended in the Financial Plan Review compared to the Council's existing approved commitments and current plans.

4.4.4 **Incremental impact of capital investment decisions on the Band D Council Tax**

	2008/09 Actual	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
Council Tax - Band D	£23.64	£(21.14)	£15.63	£9.08	£8.80

The negative amount in 2009/10 reflects a reduction in the costs of advances to borrowing accounts between 2008/09 and 2009/10. This is as a result of reduced interest rates.

4.4.5 **Estimates of the incremental impact of capital investment decisions on Housing Rent levels** – Similar to the Council Tax calculation this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in this Housing Capital Investment plan compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

4.4.6 **Incremental impact of capital investment decisions Housing Rent levels**

	2008/09 Actual	2009/10 Revised	2010/11 Estimated	2011/12 Estimated	2012/13 Estimated
Weekly Housing rent levels	£(0.41)	£(1.11)	£0.25	£0.39	£0.89

This indicator shows the revenue impact on any newly approved schemes, although any discrete impact will be constrained by rent controls.

Where the amounts in the table are negative, this is because the amount repaid on internal loans is greater than the amount of new borrowing. Where the amounts are positive, new borrowing is greater than the amount repaid on internal loans and reflects the Council's investment in affordable housing.

4.5 Treasury Management Strategy 2009/10

4.5.1 Treasury management forms an important part of the overall financial management of the Council's affairs. The prudential indicators in this report consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. Treasury Management considers the effective funding of these decisions. There are specific treasury prudential indicators included in this strategy which require approval.

4.5.2 The suggested strategy for 2010/11 in respect of the following aspects of the treasury management function is based upon the treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor.

4.5.3 A further treasury report is produced after the year-end to report on actual activity for the year.

4.5.4 The Council's Treasury management activities are regulated by the 2009 revision of the CIPFA Code of Practice on Treasury Management in Local Authorities. The Council has adopted the Code and complies with its requirements which form part of the Financial Regulations (Section 11).

4.5.5 One of the main changes to the code is the definition of Treasury Management to include reference to investments.

> "*Treasury Management is 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."*

4.5.6 The strategy covers the following:

- The Council's debt and investment projections;
- The expected movement in interest rates;
- The Council's borrowing, investment and debt rescheduling strategies;
- Treasury performance indicators;

4.5.7 The Council's Current Treasury Position

The Council's debt repayable after more than twelve months at 31st March 2009 (Actual) and 31st March 2010 (Estimated) is as follows:

		31/03/09 Actual	**Rate**	**31/03/10 Estimate**	**Rate**
		£'000	%	£'000	%
Fixed Rate Debt	PWLB	104,771	6.07	89,867	6.36
	Market	-	-	-	-
Variable Rate Debt	PWLB	-	-	-	-
	Market	33,400	4.51	33,400	4.51
Total Debt		**138,171**	**5.69**	**123,267**	**5.86**
Other Long Term Liabilities		**-**	**-**	**-**	**-**

4.6 PROSPECTS FOR INTEREST RATES

4.6.1 The Council has appointed Sector Treasury Services as treasury advisers and part of their service is to assist the Council to formulate a view on future interest rates.

4.6.2 The advisers gather a number of City forecasts for short term (bank rate) and longer term fixed interest rates. The following table gives the Adviser's central view and follows the convention used by HM Treasury in that it follows the calendar year and not Local Authority financial year. i.e. Q1 refers to January to March 2010 quarter. There is a downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected.

	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2011	Q2 2012	Q3 2012	Q4 2012	Q1 2013
Bank Rate	**0.50%**	**0.50%**	**0.75%**	**1.00%**	**1.50%**	**2.25%**	**2.75%**	**3.25%**	**3.50%**	**3.75%**	**4.25%**	**4.25%**	**4.50%**
PWLB 5 year	**3.05%**	**3.20%**	**3.30%**	**3.40%**	**3.60%**	**3.85%**	**4.15%**	**4.55%**	**4.60%**	**4.80%**	**4.80%**	**4.85%**	**4.85%**
PWLB 10 year	**4.00%**	**4.05%**	**4.15%**	**4.30%**	**4.45%**	**4.60%**	**4.80%**	**4.90%**	**5.00%**	**5.10%**	**5.10%**	**5.15%**	**5.15%**
PWLB 25 year	**4.55%**	**4.65%**	**4.70%**	**4.80%**	**4.90%**	**5.00%**	**5.05%**	**5.10%**	**5.20%**	**5.30%**	**5.30%**	**5.35%**	**5.35%**
PWLB 50 year	**4.60%**	**4.70%**	**4.75%**	**4.90%**	**5.00%**	**5.10%**	**5.15%**	**5.20%**	**5.30%**	**5.40%**	**5.40%**	**5.45%**	**5.45%**

4.6.3 There are uncertainties in all forecasts due to the major difficulties of forecasting the following areas:

- Degree of speed and severity of fiscal contraction after the general election
- Timing and amounts of reversal of quantitive easing
- Speed and recovery of banks' profitability and balance sheet imbalances
- Changes in the consumer savings ratio
- Rebalancing of the UK economy towards exporting.

4.7 Economic Background

4.7.1. The credit crunch crisis of August 2007 eventually fed through to the near collapse of the world banking system in September 2008. This pushed most of the economies of the world into a very sharp recession in 2009 accompanied by a dearth of lending from banks anxious to rebuild their weakened balance sheets. Many governments were forced to recapitalise and rescue their major banks and central banks cut their base rates in order to counter the recession.

4.7.2 The long awaited start of growth eventually came in Quarter 3, 2009 in the US and EU. However the UK failed to emerge from recession until January 2010.

4.7.3 Most major economies have resorted to a huge expansion of fiscal stimulus packages in order to encourage a fast exit from recession. This, together with expenditure on direct support provided to ailing banks, has led to a drastic expansion in government debt levels which will take many years to eliminate.

4.8 Borrowing Strategy 2009/10

4.8.1 The current uncertainty regarding the economy will ensure that caution is again adopted with regard to treasury strategy. The Chief Financial Officer will monitor interest rates and adopt a pragmatic approach to changing circumstances.

4.8.2 Borrowing rates are expected to gradually increase during the year, therefore it would be advantageous to undertake any new long term borrowing at the start of the year if 25 year PWLB rates fall back to or below the forecast rate of 4.65%.

4.8.3 Variable rate borrowing is expected to be cheaper than long term borrowing and will therefore be attractive throughout the financial year compared to taking long term fixed rate borrowing.

4.8.4 PWLB rates on loans of less than 10 years duration are expected to be substantially lower than longer term PWLB rates offering a range of options for new borrowing which will spread maturities away from a concentration in long dated debt. The Council's current repayment profile will lend itself to borrowing PWLB loans for less than 10 years.

4.8.5 There is expected to be little difference between 25 year and 50 year rates. Therefore borrowing in the 25-30 year periods could be seen as being more attractive than 50 year borrowing as the cost of early repayment rates is considerably less for these shorter period loans. This would maximise the potential for future debt rescheduling and allow rebalance of the debt maturity profile.

4.9 Debt Rescheduling

4.9.1 The introduction of the new PWLB rates structure on 1 November 2001 that introduced a spread between the rates applied to new borrowing and repayment of debt, has meant that PWLB debt restructuring is now much less attractive than before that date.

4.9.2 As short term rates will be considerably cheaper than longer term rates, there are likely to be significant opportunities to generate savings by switching from long term to short term debt. However, these savings need to be considered in the light of their short term nature and the likely cost of refinancing those short term loans, once they mature, compared to the current rates of longer term debt in the existing debt portfolio. Any such rescheduling and repayment of debt will cause a flattening of the maturity profile.

4.9.3 The reasons for any rescheduling will include:

- The generation of cash savings
- Helping to fulfil the strategy outlined within this report
- Amend the maturity profile and/or the balance of volatility

4.10 Investment Strategy 2009/10

4.10.1 The primary principle governing the Council's investment criteria is the security of capital and liquidity of its investments. The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

4.10.2 The Chief Financial Officer will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit to Council for approval as necessary. All credit ratings are monitored are monitored daily and the counterparty list is amended to reflect any changes.

- Banks – **the Council will use banks which have at least the following Fitch or equivalent ratings.** (Definitions of these ratings are shown in **Appendix 1**)
    - Short Term – F1
    - Individual / Financial Strength – C
    - Support – 1
- Bank Subsidiary and Treasury Operations – **the Council will use these where the parent bank has the necessary ratings outlined above.**
- Building Societies – **the Council will include all Societies, which meet the ratings for banks outlined above.**
- UK Government **(Debt Management Office)**
- Local Authorities **(These bodies have a statutory duty to set Council Tax so that their budgets break even)**

4.10.3 In addition to the Fitch Credit Ratings, the Council's Treasury Management Consultants provide a creditworthiness matrix to aid the assessment of risk involved in lending to individual counterparties. The Council's Counterparty List is constantly monitored in conjunction with this matrix.

4.10.4 Due to the recent changes in some UK Bank Equity structures, there has been a new rating introduced which reflects the UK Governments stake in several Banks. These banks have been classified as "Nationalised Banks" and Fitch have assigned an "F" rating and these are defined as a Bank which at some historical point of time has failed and are now owned by the Government. Likewise where a Bank has not been fully nationalised but has received substantial support from the Government, Fitch has assigned an "E" rating, being a Bank which requires external support.

4.10.5 However these institutions are now recipients of an F1+ short term rating as they effectively take on the creditworthiness of the Government itself and they have a Support Rating of 1. In other words, they have the highest ratings possible. It is on this basis that The Royal Bank of Scotland is included in the current Counterparty list. **(Appendix 2)**

4.10.6 During 2009/10 the Council took advantage of advantageous interest rates to repay £14.904M PWLB debt. In addition to reducing exposure to interest rate and credit risk, the repayments also reduced the Council's investments. It is forecast that the Council will not have any significant balances to invest during 2010/11.

4.11 Icelandic Bank Investments

4.11.1 The Council currently has £2m on deposit with the Icelandic bank, Landsbanki. This bank is in receivership and the deposit has been frozen. The Local Government Association is coordinating the efforts of all UK authorities with Icelandic investments in recovering their deposits.

4.11.2 Following submission of formal claims to Landsbanki on 30 October 2009, the Landsbanki Winding-up Board (WUB) has confirmed it has accepted all local authority claims as priority claims, subject to some modifications around the penalty interest applicable to each claim. We are pleased that the WUB has accepted the priority status of the claims. However, as anticipated, other non-priority creditors of Landsbanki (specifically bond-holders and a range of international banks) have filed objections to every decision by the WUB to accept a claim as having priority status.

4.11.3 The deadline for submitting written statements in response to objections that have been filed is 10 January 2010. Following the 10 January deadline the WUB will initiate a process of mediation, after which outstanding objections will be filed by the WUB to the courts. This means that legal action over the depositor preference issue is likely to begin in Spring 2010.

4.12 Treasury Management Prudential Indicators and Limits on Activity

4.12.1 There are three further treasury prudential indicators. The purpose of these prudential indicators 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. The indicators are:

- Upper limits on variable rate exposure – This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments.

- Upper limits on fixed interest rate exposure – Similar to the previous indicator this covers a maximum limit on fixed interest rates.

- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due to refinancing within the same financial year, and are required for upper and lower limits.

4.12.2 The Council is asked to approve the following prudential indicators:

	2009/10	2010/11	2011/12	2012/13
Interest Rate Exposures				
	Upper	**Upper**	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	100%	100%	100%	100%
Limits on variable interest rates based on net debt	30%	35%	35%	35%

Maturity Structure of Fixed Interest Rate Borrowing 2010/11		
	Lower	**Upper**
Under 12 Months	0%	20%
12 months to 2 years	0%	50%
2 years to 5 years	0%	50%
5 years to 10 years	0%	75%
10 years and above	0%	100%

Maximum Principal Sums Invested > 364 Days				
	2009/10	**2010/11**	**2011/12**	**2012/13**
Principal sums invested > 364 days *	£0M	£0M	£0M	£0M

* The use of investments greater than 364 days is currently prohibited by Scottish legislation and so this indicator is nil, until the new legislation is enacted.

4.13 Other Performance Indicators

4.13.1 The Code of Practice on Treasury Management requires the Council to monitor performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. These are:

- Debt – Average rate of borrowing for the year
- Debt – Average rate movement year on year
- Investment – Returns achieved above the 7 day LIBID rate

The results of these indicators will be reported in the Treasury Annual Report.

Author of Report: Deborah Brands, Principal Accountant – Ext.3120
Background Papers: Various working papers held within Finance and ICT
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