SOUTH WALES POLICE AUTHORITY
13 FEBRUARY 2012

SUBJECT	**TREASURY MANAGEMENT STRATEGY & PRUDENTIAL INDICATORS 2012/13**
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SUMMARY AND PURPOSE OF REPORT

To consider the recommended Treasury Management Strategy & Prudential Indicators for 2012/13

RECOMMENDATIONS	1. Adopt the Treasury Management Strategy for 2012/13 2. Adopt the Investment Strategy and counterparty criteria contained in the Treasury Management Strategy for 2012/13 3. Approve the Prudential Indicators and Limits for 2011/12 to 2015/16 4. Approve the Minimum Revenue Provision (MRP) Statement.

1 INTRODUCTION

1.1 This report updates the annual investment strategy which was previously considered by the Authority in February 2011.

1.2 The Prudential Code requires the Police Authority to set, on an annual basis, a number of Prudential Indicators. These are set in consideration of the Authority's Treasury Management Strategy and the impact of capital borrowings considered as part of the Authority's capital programme and revenue budget. The report incorporates the indicators determined for the next four financial years. Appendix A provides background information on the Prudential Code.

1.3 The current year's investment performance to December 2011 and that of the previous financial year 2010/11 are included in Appendix B.

2 TREASURY MANAGEMENT CONSULTANCY AND INVESTMENT BROKERS

2.1 A contract is agreed on an annual fee basis with Sector Treasury Services Limited to provide advice and information services. It is considered prudent to retain these services. Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remains with the Authority.

2.2 Investment and deposit dealings are undertaken via brokers, who are intermediaries with wholesale financial markets facilitating the trading activities of its clients, in particular commercial and investment banks. They are reimbursed on a commission basis. Investments and deposits are also made directly with counterparties on a more retail/ business banking basis.

Current Brokers:
Garban Intercapital Europe Limited
Tullet Prebon (Europe) Limited
King & Shaxson (including a dealing and custodian service for Deposit Certificates (CDs), treasury bills, gilts, Corporate Bonds, Floating Rate Notes, Supranational bonds and other securities - further details are outlined at Appendix C.
King & Shaxson **Update January 2012**– given scope and restriction of other current investment opportunities, required to progress. Letters of authority and contractual documents have been provided and are required to be completed prior to dealing. These are currently under review with Legal Services.

3 CURRENT ECONOMIC OUTLOOK

3.1 The Authority receives regular advice and information on the economic outlook from Sector, its Treasury Management consultants and other sources. The following are highlights from their advice on the current position, dated January 2012:

3.2 Growth in the UK economy is expected to be weak in the next two years and there is a risk of a technical recession (i.e. two quarters of negative growth). Bank Rate, currently 0.5%, underpins investment returns and is not expected to start increasing until quarter 3 of 2013 despite inflation currently being well above the Monetary Policy Committee inflation target.

3.3 Fixed interest borrowing rates are based on UK gilt yields. The outlook for borrowing rates is currently much more difficult to predict. The UK total national debt is forecast to continue rising until 2015/16; the consequent increase in gilt issuance is therefore expected to be reflected in an increase in gilt yields over this period. However, gilt yields are currently at historically low levels due to investor concerns over Eurozone sovereign debt and have been subject to exceptionally high levels of volatility as events in the Eurozone debt crisis have evolved.

3.4 Further commentary and forecasts for interest rates are included in Appendix D.

4 TREASURY MANAGEMENT OVERVIEW

4.1 Treasury Management is defined, as: “the management of the organisation’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 the optimum performance consistent with those risks”. This definition is intended to apply to all public sector organisations in their use of capital and project financings, borrowings and investments.

4.2 The Code applies to all organisations that have adopted it as part of their standing orders, financial regulations or other formal policy documents appropriate to their circumstances.

4.3 The Authority’s portfolio of investments as at the 31st March 2011 totalled **£49.059M**, which included **£13.556M** of liquid bank and cash equivalent deposits. Investment deposits held are due to the temporary positive cash flow position of the Authority and are of a short-term nature and currently include positive capital and revenue reserves.

4.4 The Authority’s portfolio of fixed rate PWLB loan, for capital purposes, as at 31st March 2011 totalled **£21.167M** with an average capital interest rate of 4.96%.

4.5 Policy Statement

4.5.1 This organisation 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.

4.5.2 This organisation 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 comprehensive performance measurement techniques, within the context of effective risk management.

4.5.3 The approved activities of the Treasury Management operation are as follows:

(a) Cash Flow (short and longer term forecasting)
(b) Investing surplus funds in Approved Investments (including short and long term investments)
(c) Borrowing to finance cash deficits, if applicable
(d) Funding of capital payments through grants, contributions, capital receipts, and borrowing
(e) Management of debt (including rescheduling and/ or monitoring for an even maturity profile)
(f) Interest rate exposure management
(g) Dealing procedures with brokers, banks, treasury advisors, UK Government Departments and Agencies including Debt Management Office and Public Works Loans Board
(h) Use of external management for temporary investment of funds.

5 TREASURY MANAGEMENT STRATEGY

5.1 Objectives for Borrowing and Investments

The major objectives to be followed in 2012/13 are: -

5.1.1 Borrowing

- To minimise the revenue costs of debt
- To manage the Police Authority's debt maturity profile i.e. to leave no one future year with a high level of repayments that could cause problems in repayment or re-borrowing.
- To effect borrowing in any one year at the cheapest cost commensurate with future risk.
- To forecast average future interest rates and borrow accordingly

- To monitor and review the level of fixed and variable interest rate loans in order to take advantage of interest rate movements.
- To reschedule debt in order to take advantage of potential savings as interest rates change.

5.1.2 **Investment**

- To maintain capital security, then liquidity then yield
- To maintain policy flexibility.
- To achieve a level of return greater than would be secured by defaulting internal investment.

5.2 Treasury Management Strategy

5.2.1 Capital Finance

To achieve the optimum funding structure for the Capital Programme, maximising the use of capital grants, prudently using capital receipts and utilising borrowing and other financing options.

5.2.2 Borrowing

To maintain a flexible approach

5.2.3 Temporary Investments

To effectively manage the use of temporary investments to maintain flexibility, and where borrowing is made in advance of requirements.

5.2.4 Debt Rescheduling

To review the possibility of debt rescheduling as and when the opportunity arises, but not to proceed unless the appropriate discounted cash flow calculations are favourable.

5.3 Annual Investment Strategy

5.3.1 This Police Authority has regard to the Welsh Government's Guidance on Local Government Investments and CIPFA's Treasury Management in Public Services: Code of Practice and Cross Sectoral Guidance Notes ("CIPFA TM Code").

5.3.2 The key requirements of both the Code and the investment guidance are to identify and approve the following:

- The strategy guidelines for decision making on investments

- The principles to be used to determine the maximum periods for which funds can be committed
- Specified investments that the Authority will use. These are high security and high liquidity investments in sterling and with a maturity of no more than a year. These would include investments which would not be defined as capital expenditure with:
  - The UK Government (such as the Debt Management Account deposit facility, UK Treasury Bills or a Gilt with less than one year to maturity).
  - Supranational bonds of less than one year's duration.
  - Corporate Bonds
  - Other securities
  - A local authority, parish council or community council.
  - Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency.

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

5.3.3 The Police Authority's investment priorities are:
(a) the security of capital
(b) liquidity of its investments
(c) the yield of the funds.

5.3.4 The Authority's investment strategy's primary objectives are firstly to safeguard the re-payment of the principal and interest of its investments on time, secondly to ensure adequate liquidity with the investment yield being a third objective.

5.3.5 Following the economic background above, the current investment climate has one over-riding risk consideration that of counterparty security risk. The Police Authority will aim to achieve the optimum yield on its investments commensurate with the proper levels of security and liquidity.

5.3.6 The general policy objective for this Police Authority is the prudent investment of its treasury balances. Balances include monies borrowed for the purpose of expenditure in the reasonably near future (i.e. borrowed 12-18 months in advance of need).

5.3.7 The Welsh Government maintains that the borrowing of monies purely to invest or on-lend and make a return is unlawful and this Police Authority will not engage in such activity.

5.3.8 The revised code requires consideration of the benchmarking and monitoring of Security, Liquidity and Yield in the Investment Service. The Authority currently benchmarks Yield but further consideration should be given to the development of benchmarking in respect of security and liquidity.

5.3.9 Yield is currently benchmarked to assess investment performance against the following measures: Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID rate
- Investments – External fund managers - returns 10% above 7 day compounded LIBID.

5.3.10 Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. However they have not previously been separately and explicitly set out. In the other investment categories appropriate benchmarks will be used where available. Whilst it is possible to develop numerical analysis, the interpretation of the results are very subjective and further review may be required. Benchmarks are guides and so may be breached from time to time.

5.4 Investment Counterparty Strategy - Criteria and proposed amendments

5.4.1 The primary principle governing the Authority's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Authority will ensure:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.
- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Authority's prudential indicators covering the maximum principal sums invested.

5.4.2 The Director of Finance will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to the Authority for approval as necessary. This criteria is separate to that which chooses Specified and Non-Specified investments as it provides an overall pool of counterparties considered high quality the Authority may use rather than defining what its investments are.

5.4.3 The rating criteria use the lowest common denominator (LCD) method of selecting counterparties and applying limits. This means that the application of the Authority's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Authority's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with a CIPFA Treasury Management Panel recommendation in March 2009 and the CIPFA Treasury Management Code of Practice.

5.4.4 Credit rating information is supplied by our treasury consultants on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance a negative rating watch applying to a counterparty at the minimum Authority criteria will be suspended from use, with all others being reviewed in light of market conditions. Similarly if a counterparty is upgraded following suitable consultation, so that it fulfils the Police Authority's criteria, it will be included in the Counterparty List.

5.4.5 This Police Authority relies on credit ratings published by Fitch Ratings, Moody's Investors Service or Standard & Poor's to establish the credit quality of counterparties (issuers and issues) and investment schemes. The Police Authority has also determined the minimum long-term and short-term and other credit ratings it deems to be "high" for each category of investment.

5.4.6 Additional requirements under the Code of Practice now require the Authority to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps), negative rating watches/ outlooks) will be applied to compare the relative security of differing investment counterparties. Credit Default Swaps (CDS) are currently considered more responsive of market factors than rating changes, with the lower the measure the lower the perceived risk.

5.4.7 The criteria for providing a pool of high credit quality investment counterparties (both Specified and Non-specified investments) are considered further. This table sets out the authorised deposit takers for the authority and details the proposed organisational limit for each category:

	Deposits and other investments (advisory note- term currently limited to **3months** due to ongoing market conditions)	**Specified or Non specified Indicator**	**Current Limit £m**	**Proposed Limit £m**
A	UK clearing banks and their wholly-owned subsidiaries **Including** those with a very high likelihood of UK Govt Support **(tier1)** (see below consideration)	Specified. Non specified if non rated	10	10

		subsidiary or > 1 year		
B	Other banks i.e. major non-clearing banks	Specified	10	10
B	Other banks i.e. smaller banks **Including** those with a high likelihood of UK Govt Support **(tier2)** (see below consideration)	Specified	5	10
C	Merchant banks		3	3
D	Oversees banks (note- currently restricted due to current market conditions)		3	3
E	Building Societies - within top 30 of Asset Size Rankings> £274m (BS guide 2011) compared to £348m (BS guide 2010). Scope reducing due to mergers and other market conditions, there appears an option to widen range from top 25 to top 30 having little change in asset size £350m to £275m. • Top 10 Rated Building Societies • Top 10 Unrated - new category (term 6 months) • 11-25 Unrated (term 6 months) • 26-30 Unrated (term 3 months) Including those originally considered Eligible Institutions by the 2008 credit guarantee scheme. In due course, it may be prudent to **exclude** those unlikely to receive UK Govt support **(tier 3)**, which would remove all smaller rated and unrated BS as circumstances may lead to failure rather than continued mergers. Asset size no longer considered relevant. (see below consideration)	Specified Non specified Non specified Non specified	5 - 3 -	10 5 3 2
F	Local Authorities	Specified	5	5
G	Nationalised industries and public corporations		3	3
H	UK Debt Management Office – Executive Agency of HM Treasury (incl. deposit, Treasury bills, gilts and other securities)	Specified Non specified if > 1 year	No Limit	No Limit
I	Call account with Authority's bankers **(tier1+2)**	Non specifie	5	10

		d		
J	Callable Accounts **(tier 1+2)** (In addition to above fixed term deposit limits)		5	10
K	External Fund Managers/ Money Market Funds (Cash and Government)	Specified	25	25

5.4.8 In further consideration of the above limits and continued advice from Treasury Management Consultants, Sector, the Authority will use, as a minimum banks which have at least the following Fitch, Moody's and Standard and Poor's ratings (where rated):

	Core credit criteria	Proposed	Current
	Short Term	F1	F1
	Long Term	A	A
	Viability (changing from Individual/ financial strength)	BBB	-
	Individual / Financial Strength	-	C
	Support	3	3

5.4.9 Advice is generally accepted, although this policy further restricts the above by limiting the bodies approved to those with a high credit quality. High is defined as:

- Short term quality, for investments of up to say 6 months of Fitch **F1** (Highest credit quality) or its equivalent from other rating agencies, including Moody's and Standard and Poor's i.e. **P-1/ A-1,** for Banks and Building Societies. Allow the use of the Authority's own banker if it falls below the above criteria.
- Longer term quality, which would be applicable for the 'mid term', say 6 -12 months of **A** (High Credit quality). The Authority will only use banks/ building societies which are:
  UK Banks; and/ or
  Are non-UK and domiciled in a country which has a minimum Sovereign long term rating of AA+.
- Longer term quality, applicable beyond 364 days of **AA-** (Very high credit quality).
- Deposits may include current account and notice period direct dealing opportunities.
- Deposits with Building Societies.
- Local Authority investments, having the backing of funding from UK government.
- Deposits with the UK Debt Management Office, an agency of the UK Government/ Bank of England and UK Government gilts.

- Deposits with Nationalised Banks or Banks/ Building Societies covered by Government guarantees (where sovereign rating of government is **AAA**)
- **AAA** (Highest credit quality) rating for Money Market Funds.
- Counterparty limits maybe exceeded by 10% as an option following approval by the Treasurer/ Director of Finance.
- non-UK and domiciled in a country which has a minimum Sovereign long term rating of **AA+.**
- Due care will be taken to consider the country, group and sector exposure of the Authority's investments. In part the country selection will be chosen by the credit rating of the Sovereign state. In addition:
  - no more than say 20%, will be placed with any non-UK country at any time;
  - limits in place above will apply to Group companies;
  - Sector limits will be monitored regularly for appropriateness.

5.4.10 Investments within the above rated criteria are defined "specified investments". These investments include those in sterling, or of not more than one-year maturity or which could be for longer but where the authority has the right to be repaid within 12 months if it wishes. These are considered low risk assets.

5.4.11 **Tier 1 + Tier 2 Banks and Building Societies (BS)**

Deposits with unrated Banks and Building Societies are classed as non-specified investments and are permitted. Not all Building Societies require or have chosen to be rated. In every other respect the security of the society would match similarly sized societies with ratings. However, following review by the UK Government, effective October 2008, a number of these institutions received the backing of the 2008 Credit Guarantee Scheme. Whilst this scheme is now somewhat out of date, it allows certain high street institutions to be included who would otherwise fail on an individual rating. This avenue would provide the Authority a useful tool for investing relatively small amounts of money for short periods of time.

The rating downgrades by Moody's in October 2011 position the ratings of UK financial institutions into three groups or tiers:
Tier 1) Banks with a very high likelihood of support: two to three notches of systemic uplift.
Tier 2) Banks with a moderate or high likelihood of support: one notch of systemic uplift.
Tier 3) Institutions with a low or no likelihood of support: no systemic uplift.

The above proposed limits allow for more funds to be deposited in tier 1 and tier 2 banks in view of the increased likelihood of continued Government support.

Extract from 7.10.11 Sector Credit rating update
Tier 3-Institutions with a low or no likelihood of support: no systemic uplift.

Moody's considers that there is insufficient certainty surrounding the likelihood and extent of support available over the medium-term to the senior creditors of rated building societies. Therefore, there is no rating uplift incorporated for systemic support from their respective standalone credit strength ratings.

Moody's believes that the government is likely to continue to provide some level of support to systemically important financial institutions, which continue to incorporate up to three notches of uplift, i.e. tier 2 and 1. However, it is more likely now to allow smaller institutions to fail if they become financially troubled.

Suggested application of this advice:
The above policy reflects consideration to exclude tier 3 Institutions, i.e. those which Moody's advise as having a low or no likelihood of UK Govt support being applicable to smaller rated BS and by 'default' equally applying to unrated BS, there being no other formally assessed credit assessment, to apply. The above criteria do take account of and reflect Moody's advice to include tier 2 and tier 1banks, which are suggested as having a **high and very high likelihood of UK Govt Support**. This amendment, to exclude tier 3 rated and unrated BS, shall be **very restrictive** and limit investment opportunities even further.

5.4.12 New advice has been recently received, which affects the continued application of the policy mainly affecting unrated Building Societies, the following is an extract:

Extract 12.01.2012 Sector Credit Policies
Credit policy should be driven by formally assessed credit quality rather than by asset size and league table ranking. Following the reduction in building society numbers and strength in the late 1990's, the capacity of one society to rescue an ailing member is uncertain.

Suggested application of this advice:
The above policy reflects consideration to vary the money and time limits and to extend or spread wider the continued risk from the top 25 to the top 30. This option appears to be based on little change in their asset size £350m to £275m. The position shall continue to be monitored.

5.4.13 Other Investments may include the following, which is an extract from definitions used by the UK Governments Department for Communities and Local Government. Assuming further contact with Investment brokers it is proposed to consider the following investment types:

Securities
- HM Treasury Bills
- CDs issued by Banks in UK
- CDs issued by Building Societies in UK
- British Government Securities
- Other Securities

Loans
- Other financial intermediaries
- Public Corporations
- Local Government
- Other

5.4.14 Giving due consideration to the Police Authority's level of balances over the next 3 years, the need for liquidity, its spending commitments and provisioning for contingencies, the Police Authority has determined that no more than **£10m** of its overall fund balances can be prudently committed to longer term investments (i.e. those with a maturity exceeding a year). Currently, this amount is **nil** and given the scope of financing over the medium term, this is likely to continue to be the case.

5.4.15 All other investments that have lower or no credit ratings or longer than 364 days are defined as Non-Specified Investments and may be entered into following advice from the Authority's Treasury Management Consultants. Earlier reference is made to the upper limit for investments longer than 364 days as being a total of **£10m**. With regard to Non-specified investments for lower or no credit ratings, which would include unrated building societies, considered above and which currently forms the majority of investment deposits, a limit of **£50m** is proposed. (This is an increase of 10m over the current limit.) The total limit for non specified investments would therefore be **£60m**.

5.4.16 Based on its current cash flow, the Police Authority anticipates its fund balances in 2012/13 to range between £10m and £75m. The minimum amount of its overall investments that the Police Authority will hold in short-term investments is **nil**.

5.5 Approved Methods and Sources of Raising Capital Finance

5.5.1 The following list specifies which borrowing instruments can be adopted and other sources of finance available:

Borrowing Instruments	Fixed Borrowing	Variable Borrowing
PWLB	✓	✓
Market Long Term	✓	✓
Market Temporary	✓	✓
European Investment Bank	✓	✓
Local Bonds	✓	
Overdraft		✓
Negotiable Bonds	✓	✓
Stock issues	✓	✓
Commercial Paper	✓	
Medium Term Notes	✓	
Bills	✓	
Other Sources of Finance		
Revenue budget contributions		
Capital Receipts		
Leasing – Operating and Finance Leases		
Deferred Purchases		
Grants		
Lottery Monies		
Joint Arrangements		
PFI		

5.5.2 The Police Authority has no policy to restrict the type of borrowing instruments required and all the above are available to the Treasurer when considered appropriate. It is, however anticipated that in practice borrowing will be confined to-

(a) PWLB
(b) Market temporary
(c) Market Long Term
(d) Overdraft
(e) Leasing

5.5.3. There continues to be no supported borrowing, which was a decision of the UK Government and the Home Office in the 2011/12 settlement. Consequently, the funding required is now considered unsupported in that it no longer features in the distribution of RSG, although this had not affected the total of RSG. The principles of the Prudential Code will be applied to all borrowing. It is proposed to borrow additionally for an additional Bridewell requirement regarding Custody proposals in the medium term. The additional capital investment cost will be offset by recurring savings in terms of operating costs, on an 'invest to save' basis.

	2011/12	2012/13	2013/14	2014/15	2015/16
	Actual £m	Estimate £m	Estimat e £m	Estimat e £m	Estimate £m
New borrowing- annual sum	1.671	1.671	1.671	1.671	1.671
New prudential borrowing (total of £1.4m, with £0.482m borrowed in 2010/11)	918	-	-	-	-
New prudential borrowing (Bridewell requirement)	-	4,000	11,000	-	-
Alternative financing arrangements	-	-	-	-	-
Replacement borrowing (option to be kept under review)	-	-	-	-	-
TOTAL	2.589	5.671	12.671	1.671	1.671

5.6 **The Sensitivity to Interest Rate Movements**

5.6.1 Future reports will be required to disclose the impact of risks on the Authority's treasury management activity. Whilst most of the risks facing the treasury management service are addressed elsewhere in this report (credit risk, liquidity risk, market risk, maturity profile risk), the impact of interest rate risk is discussed but not quantified. The table below highlights the estimated impact of a 1% increase/ decrease in all interest rates to treasury management costs/ income for next year. That element of the debt and investment portfolios, which are of a longer term, fixed interest rate nature will not be affected by interest rate changes.

	2012/13 Estimated	2012/13 Estimated +1%	2012/13 Estimated -1%
Revenue budgets:			
Interest on Borrowing	£1.0m	Long term fixed	Long term fixed
Investment income	£0.6m	+£0.4m	-£0.4m

6. PRUDENTIAL INDICATORS

6.1 The following Prudential Indicators are required to be set and approved by the Police Authority in accordance with the Prudential Code.

6.2 These are based on the suggested Capital Programme of February 2012, which outlines actual capital expenditure prior to 2011/12 and estimates of capital expenditure to be incurred.

No.	PRUDENTIAL INDICATORS FOR PRUDENCE	2011/12	2012/13	2013/14	2014/15	2015/16
		Estimated	Estimated	Estimated	Estimated	Estimated
		£000s	£000s	£000s	£000s	£000s
1	Estimates of Capital Expenditure	**12,152**	**27,982**	**13,054**	**10,439**	**19,311**
2	Capital Financing Requirement (CFR) (as at 31 March)	**22,192**	**27,301**	**39,666**	**41,650**	**43,732**
3	External Borrowing	**21,825**	**25,423**	**31,916**	**20,462**	**20,077**

6.3 Capital Financing Requirement

6.3.1 The Capital Financing Requirement measures the Authority's underlying need to borrow for capital purposes and is linked to Asset Values and proposed capital expenditure. In accordance with best practice there is no association between individual loans and particular types of expenditure. External Borrowing arises as a result of both capital and indirectly revenue expenditure and funding. Therefore, the Capital Financing Requirement and actual external borrowing can be very different.

6.3.2 As part of the previous capital strategy, prudential borrowing of up to £1.4m in 2010/11 and 2011/12 was approved to part finance the previous capital programme. New unsupported borrowing of £15.0m is required for the suggested future programme. The revenue budget requirement proposed for 2012/13 and 2013/14, includes appropriate provision to meet additional repayments with regard to all estimated borrowings.

6.3.3 One of the Prudential Indicators for Prudence, called the Net Borrowing and Capital Financing Requirement requires that:

"In order to ensure that over the medium term net borrowing will only be for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years." This indicator is anticipated to be met.

6.4 Minimum Revenue Provision (MRP)

6.4.1 The Authority is required to pay off an element of its Capital Finance Requirement each year through a revenue charge or Minimum Revenue Provision (MRP). That element is set by regulation and is currently 4% of an adjusted CFR. The Authority is also allowed to charge additional voluntary payments (VRP). In order that repayments are funded by Police Grant and

Precept, it is necessary that MRP and VRP charges to the Revenue Account equals the actual and estimated values for debt repayments.

6.4.2 Regulations require the full Police Authority to approve **an MRP Statement** in advance of each year. Revised regulations came into force on 31 March 2008, replacing the former legislative basis. Whilst the regulations revoke former MRP requirements, authorities are allowed to continue historical accounting practice. A variety of options are provided to authorities to replace the existing Regulations, so long as there is a prudent provision.

6.4.3 The Authority is recommended to approve the following MRP Statement, which is unchanged from last year:

6.4.4 For capital expenditure incurred before 1 April 2008, or which in the future will be funded by Supported Borrowing, the MRP policy will be:

Existing practice - MRP will follow the existing practice outlined in former Regulations

For all prudential borrowing after April 2008, the MRP policy will be:

Asset Life Method – MRP will be based on the estimated life of the assets, in accordance with the regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction).

6.4.5 The proposal to draw down further prudential borrowing to finance capital expenditure requires consideration of the increased amount of MRP and VRP. It is proposed that such financing is earmarked according to estimated asset lives linked to property or other schemes as appropriate. Given that MRP and VRP equal the total and thereby funded by grants and precept in totality, there is no unfunded implication.

6.5 Prudential Indicators for Affordability

No.	**PRUDENTIAL INDICATORS FOR AFFORDABILITY**	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**2015/16**
		Estimated	Estimated	Estimated	Estimated	Estimated
4	Ratio of Financing Costs to Net Revenue Stream	4.24%	4.30%	4.55%	4.39%	4.24%

Impact of Capital Investment Decisions on Council Tax

5	Increase in Band D Council Tax as per Capital Programme (incl. prudential Borrowing)	£5.60	£6.25	£8.19	£8.17	£8.17
6	Increase in Band D Council Tax – Desirable Schemes	-	-	-	-	-

6.5.1 The estimates of Financing Costs include current commitments as outlined in the current capital programme. Financing Costs include external interest, the Minimum Revenue Provision and Voluntary Revenue Provision of debt repayments charged to the Consolidated Revenue Account. This is necessary to finance the total of revenue repayments from police grant and precept. The Net Revenue Stream is the Budget Requirement of the Police Authority.

6.5.2 The estimate of the incremental impact of capital investment decisions on Council Tax (No. 5) is the future effect of the suggested Capital Programme on levels of Council Tax (Band D charge). This includes estimates for borrowing repayments, interest financing costs and the budgeted revenue contribution.

6.5.3 The increase in 2013/14, takes into account the additional prudential borrowing, for the bridewell scheme equating to an additional £2.67 Band D council tax in gross terms without taking into account efficiency savings in terms of operating costs.

6.6 Prudential Indicators for Treasury Management

No.	PRUDENTIAL INDICATORS FOR TREASURY MANAGEMENT	2011/12	2012/13	2013/14	2014/15	2015/16
		Estimated	Estimated	Estimated	Estimated	Estimated
		£m	£m	£m	£m	£m
7	**Authorised limit for external debt -**					
	Borrowing	23.8	28.4	34.9	23.5	23.1
	Other long term liabilities	-	-	-	-	-
	TOTAL	23.8	28.4	34.9	23.5	23.1
8	**Operational boundary -**					
	Borrowing	22.8	26.4	32.9	21.5	21.1
	Other long term liabilities	-	-	-	-	-
	TOTAL	22.8	26.4	32.9	21.5	21.1
9	**Upper limit for fixed interest rate exposure**					
	Net principal re fixed rate borrowing / investments	100%	100%	100%	100%	100%
10	**Upper limit for variable rate exposure**					
	Net principal re variable rate borrowing / investments	25%	25%	25%	25%	25%
11	**Upper limit for total principal sums invested for over 364 days**	10.0	10.0	10.0	10.0	10.0
	(per maturity date)					

6.6.1 The Authorised Limit for External Debt and Operational Boundary separately identifies borrowing from other Long Term Liabilities such as finance leases. The limits are consistent with the Authority's current commitments, existing plans, approved revenue and capital budgets, and approved Treasury Management Policy. They also have regard to risk management strategies, estimates of capital expenditure, capital financing requirements and cash flow projections.

6.6.2 The Operational Boundary is based on the estimate of most likely, prudent but not worst case scenario and represents a key management tool for in year monitoring. The Authorised Limit includes additional headroom to allow for unusual cash movements.

6.6.3 The Police Authority is asked to recommend these limits and to delegate authority to the Treasurer and Director of Finance to effect movement between the separate agreed annual limits for borrowing and other long term liabilities in accordance with option appraisal and value for money.

- The Authority is asked to note that the Authorised Limit for each year will be the statutory limit determined under Section 3(1) of the Local Government Act 2003.

- Upper limits for fixed interest rate exposures have been set for each year as 100% of outstanding principal sums.

- Upper limits for variable interest rate exposures have been set for each year as 25% of outstanding principal sums.

- This means that the Treasurer and Director of Finance will manage fixed interest rate exposures between 100% and 75% and variable rate exposures between 25% and 0% for each year.
- The amount of projected borrowing that is fixed rate, maturing in each period as a percentage of total projected fixed rate borrowing is:

13	**Maturity structure of new fixed rate borrowing 2011/12**	upper limit	lower limit
	under 12 months	20%	0%
	12 months and within 24 months	20%	0%
	24 months and within 5 years	50%	0%
	5 years and within 10 years	60%	0%
	10 years and above	50%	0%

7 DELEGATED POWERS

7.1 Police Authority: The setting of borrowing limits and Prudential Indicators requires the resolution of the full Police Authority.

7.2 Chief Financial Officer/ Treasurer and Director of Finance: delegated powers are contained in the Police Authority's Financial Regulations and are as follows:

> *13.5. The Authority delegates responsibility for the implementation and monitoring of its treasury management practices to the Treasurer and for the execution of treasury management decisions to the Director of Finance, who will act on behalf of the Chief Constable in accordance with the Authority's policy statement and TMPs and if a CIPFA member with CIPFA's Standard of Professional Practice on Treasury Management*. (In the interim, the Chief Financial Officer/ Treasurer and the Director of Finance is the same person.)

7.3 In practice members of the Corporate Finance Department carry out most of the work, a summary of the roles of the staff concerned is contained in Appendix E.

8 RECOMMENDATIONS

8.1 Adopt the Treasury Management Strategy for 2012/13

8.2 Adopt the Investment Strategy and counterparty criteria contained in the Treasury Management Strategy for 2012/13

8.3 Approve the Prudential Indicators and Limits for 2011/12 to 2015/16

8.4 Approve the Minimum Revenue Provision (MRP) Statement

9 LEGAL AND HUMAN RIGHTS CONSIDERATIONS

The report forms part of the monitoring and control of the Police Fund as the Authority is responsible under Section 14 (Police Act 1996.)

10 PERSONNEL, EQUAL OPPORTUNITIES AND DIVERSITY ISSUES

There are no personnel, equal opportunities or diversity issues arising from this report.

11 LIST OF BACKGROUND PAPERS

Treasury Management Policy Statement Report February 2011.

APPENDIX A

PRUDENTIAL CODE

1. **Background**

1.1 The complex system of capital controls, introduced by the Local Government and Housing Act 1989, was replaced in April 2004 by a system of self-regulation. Local Authorities are required by regulation to have regard to the Prudential Code when carrying out their duties under Part 1 of the Local Government Act 2003. The basic principle of which is that local authorities will be free to invest so long as their capital spending plans are affordable, prudent and sustainable. The compliance framework being *The Prudential Code for Capital Finance in Local Authorities* developed by CIPFA. A fully revised second edition (**the Prudential Code**) has been updated following consultation on its original implementation and following the fall-out of the Icelandic Banks crisis.

2. The Prudential Code

2.1 The objectives of the Code are to:
- ensure that local authority capital programmes are affordable
- keep local authority borrowing and credit within prudent and sustainable levels
- take treasury management decisions in accordance with professional good practice.

2.2 In taking decisions about these three key objectives local authorities must make sure that they are accountable by providing a clear and transparent framework. That framework must be consistent with and support:
- local strategic planning
- local asset management planning
- proper option appraisal

2.3 The Code aims to do this by requiring local authorities to prepare reports setting out a series of "prudential indicators" for submission to their budget-making body, at budget setting meetings.

Main Requirements of Codes

1st Code (2002)
- affordability - for example implications for the council tax
- prudence and sustainability - for example implications for borrowing
- financing costs
- value for money
- the need to provide for the cost of looking after its assets
- its objectives
- practicality

2nd Revised Code (2009)
- increased emphasis on capital/ strategic planning…
- service objectives e.g. strategic planning
- stewardship of assets e.g. asset management planning
- value for money e.g. option appraisal

- prudence and sustainability e.g. implications for external borrowing and whole life costing
- affordability e.g. implications for council tax
- practicality e.g. achievability of the foreward plan

subject to subsequent annual amendments/ addendum's of a technical nature.

APPENDIX B

5 TREASURY MANAGEMENT PERFORMANCE (to December 2011)

5.1 In line with the Authority's Treasury Management Policy, surplus monies were invested with authorised deposit takers during the first nine months of 2011/12 resulting in returns totalling £0.4M, with a forecast return of £0.5M compared to the £0.6M investment income target for the full year. In terms of current investments, the UK Government/ Bank of England bank base rates continue to be held at 0.5%, which will restrict future investment returns until there are changes in the economic climate. Further details of the Treasury Management Strategy for 2011/12 were considered and approved by the Authority in February 2011.

5.2 A detailed analysis of investments made up to 31 December2011 is shown at Appendix B, this is for illustrative purposes only and gives a broad indication of the level and spread of investment activity undertaken to date. In total 53 investments (£110.8M) have been made with 21 institutions at an average investment of £2.1M.

5.3 This interest achieved up to 31st December 2011 of £0.4M is equivalent to an average return of 1.00% (excluding investments made in 2010/11 maturing in 2011/12), which is +0.5% above the average bank base rate of 0.5% for that same period. The comparative figures for 2010/11 were 0.79%, being +0.29% above an average base rate of 0.50%. The existing Treasury Management Policy limits the investment opportunities to a small number of counterparties and therefore limits the scope on returns. This review does however note an improved average rate of return.

5.4 During October 2011, the main rating agencies have announced changes to their ratings of UK banks and building societies, following continued reviews and analysis of likely future UK Government support. They conclude that there is now more likelihood of the UK Government allowing smaller UK banks to 'fail', whilst suggesting that larger UK banks would continue to receive 'systemic' support. This appears to be a commentary and an update to the previous UK Governments 'eligible institution/ credit guarantee' scheme of 2008 which is now somewhat out of date.

5.5 As a consequence, the Authority has a much reduced scope for placing future deposit investments, based solely on credit ratings.

5.6 Given the continued commitment by the UK Government to support the main UK banks, including those partly nationalised (mainly Lloyds and RBS), there appears an option to consider keeping certain named banks on the approved list, so as to share liquidity and risk appropriately with other liquid deposits held with the Authority's Bankers, which remains outside the investment credit criteria.

5.7 It is recommended to limit this revision to those in support of level 1 systemic support only (i.e. Lloyds, RBS, HSBC, Barclays). This may allow new deposits with their subsidiaries, including for example Lloyds Group – Bank of Scotland. This position shall be monitored very closely in the interim.

5.8 During the first nine months of 2011/12, the following volume use has been made of brokers :

	No. of Transactions	
	2011-12 to December	2010-11
Garban Intercapital Europe Limited	22	38
Tullet Prebon (Europe) Limited	28	39
Direct with Investor	3	26
Direct with UK Debt Management Office	-	8
Total	**53**	**111**
Direct with Callable Accounts	13	20

5.9 In terms of Icelandic deposits, a further three instalments totalling £579k were received in April, July and October 2011 from the UK subsidiary Heritable Bank plc, with future repayments expected quarterly. This increases the total repayment received to £2.583M of the £4M invested, with 85% anticipated in total. The Authority also had £3M deposited with its parent Landsbanki, an Icelandic Bank. The Landsbanki test case appeal hearings took place in the Supreme Court of Iceland in September 2011. At the end of October 2011, the Court delivered its decision and upheld the decision of the Icelandic District Court and has ordered that deposits placed by the test case UK wholesale depositors have priority status. It is anticipated that an instalment shall be received shortly, in a mixture of currencies, including sterling, US dollars, euro's and Icelandic krona. All foreign currencies shall be required to be converted to sterling. Exact timings and amounts of recovery are not yet certain. Full settlement may still take a number of years.

5.10 Borrowing

The Authority has budgeted to borrow sums to partly finance Capital Expenditure over long term repayment terms. Further details were outlined in the Capital Programme and repayments reflected in the Revenue Budget approved in February 2011. During November the full estimated loan requirement of £2.6M was actioned at a time of comparatively low rates and in anticipation of continuing difficulties in the eurozone economies resulting in possible and significant upward movement in UK gilt and debt interest rates.

Analysis of 2011/12 Treasury Management Investments

Up to and Including : 31/12/2011
(excluding investments made in 2010/11 maturing in 2011/12)

BORROWER	Total Invested £m	No. of Investments	Average Investment £m	Average Days Invested	Average Interest Rate	Total Interest £
Bank of Scotland	12.3	3	4.1	108	1.32	47,896
Clydesdale Bank	6.0	2	3.0	54	0.54	4,858
Coventry Building Society	5.0	4	1.3	85	0.76	11,296
Cumberland Building Society	6.0	4	1.5	108	0.93	16,323
Darlington Building Society	4.0	3	1.3	138	1.07	18,278
Hinckley and Rugby Building Society	6.0	4	1.5	119	0.98	19,156
Leeds Building Society	8.0	2	4.0	132	0.99	29,152
Manchester Building Society	4.0	4	1.0	140	1.15	18,926
Market Harborough Building Society	4.5	3	1.5	153	1.22	23,587
National Counties Building Society	7.0	4	1.8	98	0.98	17,626
Nationwide Building Society	2.0	1	2.0	46	0.53	1,336
Norwich & Peterborough Building Society	3.0	1	3.0	119	1.05	10,270
Nottingham Building Society	3.0	2	1.5	187	1.26	19,317
Principality Building Society	6.0	3	2.0	115	0.97	19,747
Progressive Building Society	9.0	3	3.0	110	1.00	27,444
Saffron Walden Herts & Essex Building Society	6.0	2	3.0	108	1.03	18,177
Furness Building Society	6.0	2	3.0	147	1.16	28,369
Skipton Building Society	6.0	2	3.0	129	0.96	20,374
Cambridge Building Society	3.0	2	1.5	126	0.91	9,639
Ipswich Building Society	3.0	1	3.0	87	0.80	5,721
Tipton & Coseley Building Society	1.0	1	1.0	117	1.10	3,526
Grand Total	**110.8**	**53**	**2.1**	**117**	**1.00**	**371,017**

6 Review of Treasury Management Performance (2010/11)

6.1 In line with the Authority's Treasury Management Policy, surplus monies were invested with authorised deposit takers during 2010/11 resulting in returns totalling £0.5M, which compares to £0.6M for the previous year.

6.2 In terms of current investments the UK Government/ Bank of England bank base rates continue to be held at 0.5% and that will restrict future investment returns until there are changes in the economic climate. This was reflected in the investment income budget set for 2010/11 of £0.6M. Further details of the Treasury Management Strategy for 2010/11 were considered and approved by the Authority in February 2010.

6.3 A detailed analysis of investments made up to 31 March 2011 is shown at Appendix D, this is for illustrative purposes only and gives a broad indication of the level and spread of investment activity undertaken to date. In total 111 investments (£227.9M) have been made with 22 institutions at an average investment of £2.1M.

6.4 This interest achieved for 2010/11of £0.5M is equivalent to an average return of 0.79% (excluding investments made in 2009/10 maturing in 2010/11), which is +0.29% above the average bank base rate of 0.5% for that same period. The comparative figures for 2009-10 were 1.20%, being +0.70% above an average base rate of 0.5%. The existing Treasury Management Policy limits the investment opportunities to a small number of counterparties and therefore limits the scope on returns.

6.5 No use has been made of delegated powers during 2010/11 or the current year to date.

6.6 The Authority continues to receive a good service from their money brokers Garban Intercapital Europe Limited and Tullet Prebon (Europe) Limited which facilitated the investment returns detailed above. During 2010/11, the following volume use has been made of brokers:

	No. of Transactions	
	2010-11	2009-10
Garban Intercapital Europe Limited	38	61
Tullet Prebon (Europe) Limited	39	79
Direct with Investor	26	39
Direct with UK Debt Management Office	8	9
Total	111	188
Direct with Callable Accounts	20	-

7 Borrowing

7.1 The Authority undertakes borrowing annually in line with the Capital Financing settlement from the Government, which is typically £1.7M per annum. However, the Prudential Code permits the Authority to determine its own borrowing requirements provided this is affordable and sustainable.

7.2 During the year a total of £2.1M was borrowed from the Public Works Loan Board (PWLB) to partly finance capital expenditure, of which £1.7M was supported borrowing and £0.5M on a prudential basis. The Authority budgeted to borrow these sums which partly finance capital expenditure.

Analysis of 2010/11 Treasury Management Investments

(excluding investments made in 2009/10 maturing in 2010/11)

BORROWER	Total Invested £m	No. of Investments	Average Investment £m	Average Days Invested	Average Interest Rate	Total Interest £
Bank of Scotland	40.0	18	2.2	88	1.06	114,985
Barclays Bank	11.0	4	2.8	78	0.65	15,928
Clydesdale Bank	6.0	2	3.0	90	0.63	9,566
Coventry Building Society	8.0	4	2.0	62	0.56	7,333
Cumberland Building Society	2.0	1	2.0	95	0.80	4,164
Darlington Building Society	2.0	2	1.0	154	0.83	7,174
Debt Management Office (DMO)	30.2	8	3.8	7	0.25	1,457
Hinckley and Rugby Building Society	9.0	6	1.5	118	0.85	25,018
Kent Reliance Building Society	10.0	6	1.7	93	0.79	19,981
Leeds Building Society	8.0	3	2.7	151	0.81	26,950
Manchester Building Society	7.0	5	1.4	58	0.67	7,736
Market Harborough Building Society	4.0	3	1.3	126	0.93	16,495
National Counties Building Society	9.0	6	1.5	136	1.04	34,653
Nationwide Building Society	10.0	3	3.3	50	0.52	6,226
Norwich & Peterborough Building Society	12.0	8	1.5	85	0.79	31,575
Nottingham Building Society	7.5	5	1.5	153	1.08	34,839
Principality Building Society	15.0	8	1.9	67	0.63	16,864
Progressive Building Society	6.0	2	3.0	136	0.95	21,263
Saffron Walden Herts & Essex Building Society	14.0	8	1.8	80	0.86	32,824
Santander UK plc	7.2	4	1.8	34	0.81	4,696
Stroud & Swindon Building Soceity	7.0	4	1.8	58	0.64	6,472
Furness Building Society	3.0	1	3.0	178	1.15	16,825
Total/Overall Average	**227.9**	**111.0**	**2.1**	**95**	**0.79**	**463,024**

APPENDIX C

BROKER – KING & SHAXSON

This broker is a registered financial institution that is regulated by the Financial Services Authority and offers the following services:

Cash Fixed term deposits

Certificates of Deposits (CDs), including dealing and custodian facilities

These are similar to deposits, receiving a fixed rate of interest for a fixed period, in exchange for a certificate. These certificates are tradable as investments and may be sold before maturity to gain access to the funds. An important critical difference is that the broker is offering to advise with regard to the Daily monitoring of securities to pinpoint possible switching opportunities to maximize yield.

Treasury Bills

These are short term securities issued by HM Treasury on a discount basis. They are very liquid, very secure and an alternative to bank counterparties and gilts.

Government Gilts

Simplest form of government Bond, which guarantees to repay a fixed flow of interest every 6 months and a fixed capital repayment on maturity.

Corporate Bonds

From April 2012, local authorities will be able to buy corporate bonds without them being considered capital expenditure, under powers granted under the Localism Act 2011. There may be some advantage of some UK and or foreign government agencies, most of which are AA or AAA rated and are therefore worth serious consideration. Maturities are currently offered for 1 to 3 years.

Floating Rate Notes

These are a money market instruments normally issued in the form of a Eurobond but with floating/ variable rate of interest. The maturity is normally between 1 and 5 years, some are issued for 10 years. The value of an FRN is judged by its ‘discount margin’ which represents the spread over LIBOR.

Supranationals

These are organisations of which the share capital is owned and guaranteed by the leading developed nations, offering more guarantee than a single country. E.g EEC, European Investment Bank (EIB), the World Bank. They issue fixed rate bonds similar to gilts, normally offered at a small premium to gilts, but less liquidity.

APPENDIX D

Prospects for Interest Rates (Extract from Sector January 2012)

The Council has appointed Sector as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table gives the Sector central view after considering a number of City forecasts for short term (Bank Rate) and longer fixed interest rates.

Annual Average %	Bank Rate	Money Rates		PWLB Borrowing Rates		
		3 month	1 year	5 year	25 year	50 year
March 2012	0.50	0.70	1.50	2.30	4.20	4.30
June 2012	0.50	0.70	1.50	2.30	4.20	4.30
Sept 2012	0.50	0.70	1.50	2.30	4.30	4.40
Dec2012	0.50	0.70	1.60	2.40	**4.30**	4.40
March 2013	0.50	0.75	1.70	2.50	4.40	4.50
June 2013	0.50	0.80	1.80	2.60	4.50	4.60
Sept 2013	**0.75**	0.90	1.90	2.70	4.60	4.70
Dec 2013	1.00	1.20	2.20	2.80	4.70	4.80
March 2014	1.25	1.40	2.40	2.90	4.80	4.90
June 2014	1.50	1.60	2.60	3.10	4.90	5.00

Growth in the UK economy is expected to be weak in the next two years and there is a risk of a technical recession (i.e. two quarters of negative growth). Bank Rate, currently 0.5%, underpins investment returns and is not expected to start increasing until quarter 3 of 2013 despite inflation currently being well above the Monetary Policy Committee inflation target. Hopes for an export led recovery appear likely to be disappointed due to the Eurozone sovereign debt crisis depressing growth in the UK's biggest export market. The Comprehensive Spending Review, which seeks to reduce the UK's annual fiscal deficit, will also depress growth during the next few years.

Fixed interest borrowing rates are based on UK gilt yields. The outlook for borrowing rates is currently much more difficult to predict. The UK total national debt is forecast to continue rising until 2015/16; the consequent increase in gilt issuance is therefore expected to be reflected in an increase in gilt yields over this period. However, gilt yields are currently at historically low levels due to investor concerns over Eurozone sovereign debt and have been subject to exceptionally high levels of volatility as events in the Eurozone debt crisis have evolved.

This challenging and uncertain economic outlook has a several key treasury mangement implications:

- The Eurozone sovereign debt difficulties, most evident in Greece, provide a clear indication of much higher counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2012/13;
- Borrowing interest rates are currently attractive, but may remain low for some time. The timing of any borrowing will need to be monitored carefully;
- There will remain a cost of capital – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

Economic Background

Global economy

The outlook for the global economy remains clouded with uncertainty with the UK economy struggling to generate sustained recovery that offers solid optimistim for the outlook for 2012, or possibly even into 2013. Consumer and business confidence levels are low and with little to boost sentiment, it is not easy to see potential for a significant increase in the growth rate in the short term.

At the centre of much of the uncertainty is the ongoing **Eurozone sovereign debt crisis** which has intensified, rather than dissipated throughout 2011. The main problem has been **Greece**, where, even with an Eurozone/IMF/ECB bailout package and the imposition of austerity measures aimed at deficit reduction, the lack of progress and the ongoing deficiency in addressing the underlying lack of competitiveness of the Greek economy, has seen an escalation of their problems. These look certain to result in a default of some kind but it currently remains unresolved if this will be either “orderly” or “disorderly”. Most commentators currently view that it is now inevitable that Greece will have to exit the Eurozone in 2012.

There is also growing concern about the situation in **Italy** and the risk that contagion has not been contained. Italy is the third biggest debtor country in the world but its prospects are limited given the poor rate of economic growth over the last decade and likely difficulties in implementing the required level of fundamental reforms in the economy. The Eurozone now has a well established track record of always doing too little too late to deal with this crisis; this augurs poorly for future prospects, especially given the rising level of electoral opposition in northern EU countries to bailing out profligate southern countries.

The US economy has encouraged with some positive news around the start of 2012 but any improvement in the weak rate of growth is likely to only generate slow progress in reducing the high level of unemployment which is acting as such a dampener on the economy. With Presidential elections due in November 2012, the current administration has been hamstrung by political gridlock with the two houses split between the main parties. In quarter 3 the Federal Reserve started “Operation Twist” in an effort to re-ignite the rate of growth in the economy. However, high levels of consumer indebtedness, a moribund housing market together with stubbornly high unemployment, will continue to weigh heavily on consumer confidence and so on the abiltity to generate a healthy and consistent rate of economic growth.

Hopes for broad based recovery have, therefore, focussed on the **emerging markets** but these areas have been struggling with inflationary pressures in their previously fast growth economies. China, though, has maintained its growth pattern, despite a major thrust to tighten monetary policy during 2011 to cool inflationary pressures which are now subsiding. However, some forward looking indicators are causing concern that there may not be a soft landing ahead, which would then be a further dampener on world economic growth.

UK economy

The Government's austerity measures, aimed at getting the public sector deficit into order over the next four years, have yet to fully impact on the economy. However, coming at a time when economic growth has been weak and concerns at the risk of a technical recession (two quarters of negative growth) in 2012, it looks likely that the private sector will not make up for the negative impact of these austerity measures given the lack of an export led recovery due to the downturn in our major trading partner – the EU. The housing market, a gauge of consumer confidence, remains weak and the outlook is for house prices to be little changed for a prolonged period.

Economic Growth. GDP growth has, basically, flatlined since the election of 2010 and, worryingly, the economic forcecasts for 2012 and beyond have been revised lower on a near quarterly basis. With concerns of a potential return to recession, the Bank of England embarked on a second round of Quantitive Easing to stimulate economic activity. It appears very likely that there will be another expansion of quantitative easing in quarter 1 2012 in order to stimulate economic growth.

Unemployment. With the impact of the Government's austerity strategy resulting in steadily increasing unemployment during 2011, there are limited prospects for any improvement in 2012 given the prospects for weak growth.

Inflation and Bank Rate. For the last two years, the MPC's contention has been that high inflation was the outcome of temporary external factors and other one offs (e.g. changes in VAT); that view remains in place with CPI inflation starting quarter 1 of 2012 at 4.8%, having peaked at 5.2% in September 2011. They remain of the view that the rate will fall back to, or below, the 2% target level within the two year horizon.

AAA rating. The ratings agencies have recently reaffirmed the UK's AAA sovereign rating and have expressed satisfaction with Government policy for deficit reduction. They have, though, warned that this could be reviewed if the policy were to change, or was seen to be failing to achieve its desired outcome. This credit position has ensured that the UK government is able to fund itself at historically low levels and, with the safe haven status from Eurozone debt also drawing in external investment, the pressure on rates has been down, and looks set to remain so for some time.

Sector's forward view

Economic forecasting remains troublesome with so many extermal influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains weak and whilst there is still a broad range of views as to potential performance, they have all been downgraded throughout 2011. Key areas of uncertainty include:

- a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- the impact of the Eurozone crisis on financial markets and the banking sector;
- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to exporting manufactured goods;
- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that inceasingly seem likely to be undershot;
- a continuation of high levels of inflation ;
- the economic performance of the UK's trading partners, in particular the EU and US, with some analysts suggesting that recession could return to both;
- stimulus packages failing to stimulate growth;
- elections due in the US, Germany and France in 2012 or 2013;
- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.

The overall balance of risks remains weighted to the downside. Lack of economic growth, both domestically and overseas, will impact on confidence putting upward pressure on unemployment. It will also further knock levels of demand which will bring the threat of recession back into focus.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

Given the weak outlook for economic growth, Sector sees the prospects for any interest rate changes before mid-2013 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

APPENDIX E

ROLES OF CORPORATE FINANCE DEPARTMENT STAFF RELATING TO TREASURY MANAGEMENT

CHIEF FINANCIAL OFFICER/ TREASURER AND DIRECTOR OF FINANCE

1. Ensure policy documents are adhered to, and that they are regularly reviewed.
2. Ensure that a review of the Treasury Management function and its performance is undertaken once a year.
3. Report to Police Authority on performance and activities of Treasury Management in accordance with the Treasury Management Policy Statement.
4. Ensure that there is a clear written statement of the responsibilities delegated to each post and arrangements for absence cover.

ASSISTANT DIRECTOR OF FINANCE

1. Deputise for the Treasurer and Director of Finance in the performance of Treasury Management as required.
2. Review the Treasury Policy Statement, assure it is complied with, and that this statement complies with the law.

HEAD OF ACCOUNTANCY SERVICES

1. Review the Treasury Policy Statement and ensure that it is complied with.
2. Ensure that Treasury Management Practices exist and are complied with.
3. Review performance of the Treasury Management function at least once a year and prepare monitoring reports and annual reports as required.
4. Ensure all persons engaged in Treasury Management activities receive appropriate training.
5. Ensure the organisation of the Treasury Management function is adequate to meet current requirements.
6. Ensure that there is adequate internal checking and division of duties.

HEAD OF FINANCIAL ACCOUNTANCY

1. Manage the overall Treasury function.
2. Prepare the Treasury Management Policy Statement.
3. Prepare and implement the Treasury Management Practices.
4. Ensure that the systems and procedures laid down in the Treasury Management Practices are complied with, and that prescribed limits are not breached.
5. Ensure appropriate division of duties in this section.
6. Ensure credit worthiness of investment counter-parties.
7. Assess and appoint brokers, and monitor the performance of brokers employed.
8. Review all loan transactions, cash flow actuals and projections and level of debt/investment on a routine basis.
9. Assist in the preparation of the Treasury Policy Statement.

ACCOUNTANT – FINANCIAL ACCOUNTANCY

1. Implement the Treasury Policy Statement
2. Prepare Cash Flow projections

3. Make daily decisions on funding, lending, acceptability of treasury instruments, and consider legality of proposed action.
4. Dealing and initial record of deal
5. Transmission procedures
6. Provide the Head of Financial Accountancy with routine reports on: transactions made, cash flow actuals and projectIons and level of debt/ investment.