Item No: 5.3	Classification: Open	Date: February 21 2007	Meeting Name: Council Assembly
Report title:		Prudential Indicators 2007/08 to 2009/10 and Annual Investment Strategy 2007/08	
Wards or Groups affected:		All	
From:		Finance Director	

RECOMMENDATIONS

1. That the Council Assembly agree:

   (i) prudential indicators covering capital finance, borrowing and cash management for the years 2007/08 to 2009/10 as set out in Appendix A.

   (ii) the investment strategy for managing cash for the year 2007/08 as set out in Appendix B.

   (iii) a capital allowance of £137.5 million, as set out in paragraph 28 of this report, enabling the Council to continue to retain capital receipts for affordable housing and regeneration that would otherwise have to be passed on to the Government under pooling arrangements.

BACKGROUND INFORMATION

2. This report brings together capital finance, borrowing and investment arrangements in a series of prudential indicators to help assess the affordability, prudence and sustainability of these activities. The indicators represent estimates and projections of financing activities and set ceilings on the debt within which the Council must remain. The indicators are part of a self-regulating financing regime brought about by the Local Government Act 2003, supporting regulations and the Prudential Code for Capital Finance in Local Authorities, published by the Chartered Institute of Public Finance and Accountancy (CIPFA). The report also details the investment strategy for managing cash in 2007/08, which continues to place the preservation of capital as a key objective.

3. The report further asks for a formal decision concerning the capital allowance to enable the Council to carry on retaining receipts for affordable housing and regeneration that would otherwise pass to the Government under pooling arrangements. The Council relies on securing these exemptions from pooling to invest in affordable housing and regeneration.

4. The indicators are determined by the Council annually and under financial delegation, the Finance Director is responsible for all executive and operational decisions on borrowings and investments. The recommendations in this report will enable the Director to continue to exercise his responsibilities in this area and follow the debt and investment strategies set out in the report.

KEY ISSUES FOR CONSIDERATION

Prudential Indicators, Capital Finance, Borrowing And Cash Management

5. Prudential indicators refer to the prudence, affordability and sustainability of capital finance, borrowing and cash management arrangements as far ahead as 2009/10. The indicators recommended for approval are set out in detail in Appendix A and key strategies the indicators draw on are set out in the body of the report.

6. The annual investment strategy 2007/06 recommended for approval is detailed in Appendix B. It is set out according to investment guidelines issued by the Government in 2004. The strategy widens the scope of permitted investments from current arrangements. It will help diversify investments and enhance returns, but continue to place priority on capital preservation and liquidity.

7. Also recommended for approval is the capital allowance as set out in para 28.

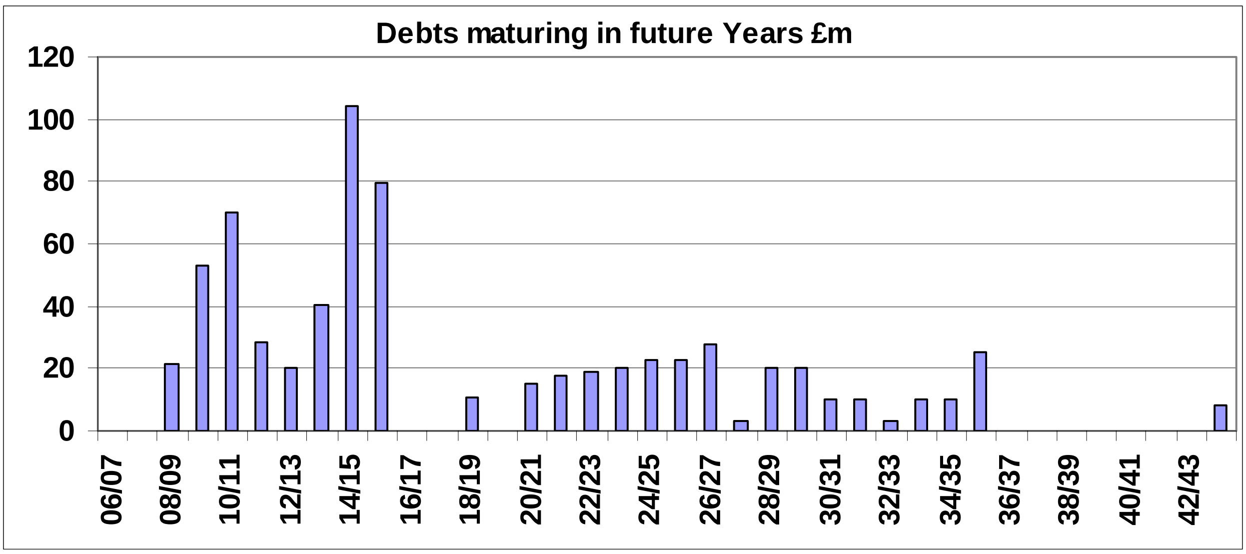
Capital Finance

8. Capital expenditure is financed out of capital receipts, grants, revenue contributions and borrowing. The expenditure in 2006/07 and 2007/08 is projected as £180 million and £181 million, respectively, and in each year £26 million is to be met out of Government supported borrowing approvals. No locally funded prudential borrowing is expected in either year. Detailed prudential indicators associated with capital finance are presented in Appendix A.

Borrowing

9. The Council takes on debt to support capital expenditure. The actual level of debt at the start of 2006/07 was £694 million and so far this year no new debt has been taken on to fund capital spend. This year's requirement was met by the £45m that was borrowed in 2005/06 from the Public Works Loans Board (PWLB, a division of the Government, and the prime source of local authority borrowing) at an average rate of 4.41% maturing between 28 and 30 years.

10. The £694 million debt is all borrowed from the PWLB at fixed rates of interest and matures and falls for refinance as set out in the chart below.



11. The average rate of interest on the historical debt is 8.8%. It is high relative to current base rate which is at 5.25%. The high average reflects a long period between the 1970's and early 1990's, unlike now, when high capital spending and debt funding coincided with years of high inflation and high interest rates. However, as most of the interest payable on debt is reimbursed in support by the Government, the impact on Council finances from the high rate is minimal. Housing Revenue Account (HRA) Subsidy is currently paid on 85% of debt at the Council's own average rate, and an allowance is included in Formulae Grant for the General Fund element.

12. With interest rates still low relative to historical levels, it remains prudent to meet Government supported approvals through new loans. The loans will provide secure long run funding and help lower the average rate of interest on debt.

13. As well as taking on new loans, regard will be given to debt refinancing to lower the net of support funding costs over the long term and to raise the flexibility of the debt to better sustain developments in financing conditions. Whilst the main source of such refinancing is likely to be the PWLB, loans from the commercial sector will also be considered where appropriate and prudent.

14. The level of refinancing opportunities is expected to be limited as it would involve paying premiums to close existing loans. A further level of uncertainty arises from proposals to bring in new accounting standards to deal with premiums and financial instruments. The standards cover debts, investments and all similar instruments and require the value of financial instruments and their consequences on revenue to closely reflect commercial valuation principles rather than cash values as now. The accounting standards currently apply to listed corporations and they cannot be applied to local authorities without changes to limit their financial impact. The Government recognises this and arrangements are being developed to mitigate the impact on councils. The developments will be kept under review as part of the Council's policy and resources strategy.

15. Outside of refinance the Council has the option of reducing down debt using capital receipts, where permitted.

16. Prudential indicators reflecting the current position on debt and accommodating flexibility to carry out refinancing options referred to here are set out in Appendix A. Over the medium term debt will only increase as is consistent with funding capital spend and any increase in debt beyond that will only be temporary and be managed prudently to enable refinancing to be completed effectively or accommodate cash flow requirements.

Cash Investment Management

17. The Council's cash balance averaged £302 million over the course of 2005/06 and as at the end of December 2006 stood at £323 million. The cash is invested across a number of counterparties which can include the Government, local authorities, and large high rated banks and building societies. Investment risk is further contained by placing limits on maturities that exceed one year.

18. Day to day investment management is carried out by an inhouse operation and Invesco Asset Management Ltd, part of the large UK investment group AMVESCAP. Invesco are used largely to gain exposure to liquid instruments or maturities beyond one year. Investment returns reflect short term money market rates, which in turn

follow base rates. The overall return for the nine months to December 2006 was 3.6%, equivalent to average base rates for this period.

19. Investments to date in 2006/07 have mostly been in deposits of up to one year. The counterparty exposure as at 31 December 2006, including the £27 million managed by Invesco is set out in the table below. Except for the £8.5 million exposure to two year UK Gilts, no maturities exceeded 1 year.

CASH INVESTMENTS as at 31 December 2006	
Counterparty	**£m**
Abbey National Plc	4.6
Allied Irish Bank	25.0
Barclays Bank	5.0
Bank of Nova Scotia	15.0
Commonwealth Bank of Australia	20.0
Deutsche Bank	25.0
HBOS (Halifax Bank of Scotland)	12.8
ING Bank	0.9
Lloyds TSB Bank	30.0
National Australia Bank	25.0
Nationwide Building Society	28.5
RBOS (Royal Bk of Scotland/NatWest)	35.8
Rabobank	25.0
Societe Generale	12.1
Svenska Handelsbanken	25.0
UBS (Union Bank Switzerland)	25.0
UK Gilts HM Treasury	8.5
Total £m	**323.2**

20. Over the course of 2006/07 cash balances are expected to average £310 million. Balances have benefited from previous expansion in resources, particularly from capital receipts. But as spend picks up and the flow of new resources slows, the cash available for investments will fall.

21. The 2007/08 investment strategy, constructed with the objective of preserving capital and maintaining a high level of liquidity, recommended for approval is set out in Appendix B. The prudential indicators, Appendix A, associated with investments have been updated to reflect this strategy.

22. The strategy, which is set out according to local authority investment guidelines issued by the Government (Department of Communities and Local Government – DCLG/ODPM), distinguishes between specified investments (which are investments that have high liquidity and credit qualities and are not beyond one year) and non-specified investments (which have maturities that exceed one year and so potentially more responsive to liquidity, credit and market factors).

23. The range of non-specified investments and ratings permitted under the 2007/08 strategy have been widened to help enhance returns and manage investment risk whilst maintaining capital security and liquidity. The sums that may be placed with the very high rated institutions have also been expanded to £40 million (from £30 million currently) to ensure the Council can continue to benefit from scale economies without compromising credit quality.

24. Following a tendering exercise, the Finance Director is also expanding the role played by external investment managers in implementing the investment strategy in 2007/08. Up to three managers will be appointed, which will give access to high quality expertise and resources, ensuring that investments are managed prudently and with limited risk.

Capital Allowance

25. As part of the Local Government Act 2003, a proportion of the proceeds from HRA asset sales are paid over to a Government ‘pool’. The percentage paid over differs according to the type of receipt, basically land is 50% and buildings 75%.

26. Receipts from social homebuy, non right to buy dwellings, land, shops and other assets can be exempt from pooling provided the money is used in the Council’s own affordable housing or regeneration programmes. This exemption does not apply to right to buy sales. The amount which may be exempt from pooling is known as the capital allowance. Council spending relies on securing these exemptions from pooling.

27. The capital allowance requires updating to reflect the receipts received and the updated estimate of the planned expenditure on affordable housing or regeneration programmes. The total value of projects incorporating these recycled receipts as part of the funding are now estimated as £137.5m.

28. Council Assembly is recommended to agree a capital allowance of £137.5 million to enable the Council to carry on retaining capital receipts for affordable housing and regeneration that would otherwise have to be passed on to the Government under the pooling arrangements. The level of allowance needed in the future will be kept under review in the light of developments in the capital programme.

SUPPLEMENTARY ADVICE FROM OTHER OFFICERS

Borough Solicitor

29. The Local Government Act 2003 and supporting regulations require local authorities to determine annual borrowing limits and have regard to the Prudential Code for Capital Finance, and the Code of Practice on Treasury Management, both published by the Chartered Institute of Public Finance and Accountancy, when determining or changing borrowing limits or prudential indicators. Reference should also be made to the ODPM Guidance on Local Authority Investments. The Council Assembly should determine borrowing limits annually before the start of the year the limits relate to and approve the prudential indicators and investment strategy proposed provided they are happy with the report.

30. Further regulations under the 2003 Act specify that the Council may retain certain capital receipts provided they are used in affordable housing or regeneration. Council Assembly is being asked to agree the capital allowance to enable receipts to be retained by the Council.

31. Members are advised to give approval to the recommendations contained in paragraph one above. In doing so, it confirms that the Council is complying with its duty under the Local Authorities (Capital Finance & Accounting) (England) Regulations 2003 (SI2003/3146) that its capital investment and borrowing plans are affordable, prudent, and sustainable.

BACKGROUND DOCUMENTS

Background Papers	Held at	Contact
Prudential Code for Capital Finance in Local Authorities. Code of Practice on Treasury Management. ODPM Investment Guidelines.	Financial Management Services, Strategic Services Department	Dennis Callaghan, Chief Accountant (020 7525 4375)

APPENDICES

No.	Title
Appendix A	Prudential Indicators – Recommended for Approval
Appendix B	Annual Investment Strategy 2007/8 – Recommended for Approval

AUDIT TRAIL

Lead Officer	Duncan Whitfield, Finance Director	
Report Author	Simon Hughes, Assistant Finance Director	
Version	Final	
Version Date	08/02/07	
Key Decision	Yes	
CONSULTATION WITH OTHER OFFICERS / DIRECTORATES / EXECUTIVE MEMBER		
Officer Title	**Comments Sought**	**Comments Included**
Borough Solicitor	Yes	Yes
Final Report Sent to Constitutional Support Services		08/02/07

PRUDENTIAL INDICATORS – RECOMMENDED FOR APPROVAL

PRUDENTIAL INDICATORS

1. Capital finance, borrowing and investment arrangements are brought together in a series of prudential indicators and limits to give a general picture of the affordability, prudence and sustainability of financing activities. The indicators and limits are grouped into three broad areas: affordability, prudence and treasury management.

2. This Appendix provides a detailed explanation of each indicator needing approval. A description of the indicators, extracted from the Prudential Code on Capital Finance for Local Authorities published by Chartered Institute of Public Finance and Accountancy, is also included.

3. The indicators needing Council Assembly approval are those for the years 2007/08 to 2009/10. (The 2005/06 indicators are shown as actuals using audited accounts, and latest projections are indicated for 2006/07.)

CRITERIA ONE: AFFORDABILIY AND PRUDENTIAL INDICATORS ON AFFORDABILITY

Extract from Prudential Code:

The fundamental objective in the consideration of the authority's capital plan is to ensure that the level of investment in capital assets proposed means that the total capital investment of the authority remains within sustainable limits, and in particular to consider the impact on the local authority's "bottom line", Council Tax. Affordability is ultimately determined by a judgement on Council Tax levels and, in the case of the Housing Revenue Account, acceptable Rent levels.

In considering the affordability of its capital plans, the authority is required to consider all of the resources currently available to it and estimated for the future, together with the totality of its capital plans, revenue income and expenditure forecasts for the forthcoming year and the following 2 years. The authority is required to consider known significant variations beyond this timeframe.

The local authority shall set and monitor against the following prudential indicators as key indicators of affordability.

INDICATOR ONE: ESTIMATES OF RATIO OF FINANCING COSTS TO NET REVENUE STREAM

Extract from Prudential Code:

The authority will estimate for the forthcoming financial year and the following 2 years the ratio of financing costs to net revenue stream. At the year end, the ratio of financing costs to net revenue stream will be calculated directly from the local authority's consolidated revenue account

Comment and Recommended Indicator

The financing ratio reflects financing costs arising from capital expenditure after income from cash balances. The GF ratio has been able to benefit from growth in working capital following expansion in Right to Buy Receipts, However, this benefit will over time erode as receipts slow down and spend picks up. The different pattern of the HRA and GF ratios reflects the different way the two services are organised under law.

Financing Ratios	2005/06 Actual	2006/07 Previous Estimate	2006/07 Latest Projection	**2007/08 Estimate**	**2007/08 Estimate**	**2009/10 Estimate**
HRA	34.2%	35.0%	35.0%	**34.0%**	**34.0%**	**34.0%**
GF	-0.7%	1.1%	-0.7%	**0.4%**	**1.7%**	**1.7**

INDICATOR TWO: ESTIMATES OF THE INCREMENTAL IMPACT OF CAPITAL INVESTMENT ON THE COUNCIL TAX AND HOUSING RENTS

Extract from Prudential Code:

The local authority will forecast the total budgetary requirements for the authority based on no changes to the existing capital programme; forecast the total budgetary requirement with the changes proposed to the capital programme included in the calculation; and take the difference between these two and calculate the addition or reduction to Council Tax that would result. This calculation shall be undertaken for the forthcoming year and the following two financial years or longer timeframe to capture the full effect of capital programme decisions.

Comment and Recommended Indicator

Additional budgetary requirements for the capital programme may arise from locally funded prudential borrowing, which unlike supported borrowing is entirely funded from the Council's revenue budget. No prudential borrowing is expected in respect of the HRA or the General Fund.

Notional Rent or Council Tax Increases	**2007/08**	**2008/09**	**2009/10**
Weekly Housing Rent increase	**Nil**	**Nil**	**Nil**
Council Tax Band D increase	**Nil**	**Nil**	**Nil**

CRITERIA TWO: PRUDENCE AND PRUDENTIAL INDICATORS FOR PRUDENCE

Extract from the Code

The prudential indicators in respect of external debt must be set and revised taking into account their affordability. It is through this means that the objective of ensuring that external debt is kept within sustainable, prudent levels is addressed year on year. 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. Ensuring that treasury management is carried out in accordance with good professional practice is an essential feature of prudence.*

INDICATOR THREE: ESTIMATES OF CAPITAL EXPENDITURE

Extract from Prudential Code

The local authority will make reasonable estimates of the total capital expenditure that it plans to incur during the forthcoming financial year and at least the following two financial years. After the year end the actual expenditure incurred during the financial year will be recorded.

Comment and Recommended Indicator

The actual capital expenditure for 2005/06 was £152 million. 2006/07 projections reflect capital cash spend profile and future years' estimates include programme approvals. The 2007/08 to 2009/10 capital expenditure estimates recommended for approval are set out below.

Capital Expenditure	2005/06 Actual £m	2006/07 Previous Estimate £m	2006/07 Latest Projection £m	**2007/08 Estimate £m**	**2008/09 Estimate £m**	**2009/10 Estimate £m**
HRA	90	82	82	**98**	**100**	**93**
GF	62	79	98	**83**	**70**	**50**
Total	152	161	180	**181**	**170**	**143**

INDICATOR FOUR: ACTUAL AND ESTIMATES OF CAPITAL FINANCING REQUIREMENTS.

Extract from Prudential Code

The local authority will make reasonable estimates of the total capital financing requirement at the end of the forthcoming financial year and the following two years. After the year end, the actual capital financing requirement will be calculated directly from the local authority's balance sheet.

Comment and Recommended Indicator

Both the HRA and the GF capital financing requirements (CFR) reflect the use of borrowing to pay for past and current capital expenditure. The latest projection for March 2007 assumes capital borrowing of £26 million (all supported: £15 million HRA, £11 million GF). The corresponding estimate for March 2008 is also £26 million (£13 million HRA, £13 million GF).

PRUDENTIAL INDICATORS – RECOMMENDED FOR APPROVAL

CFR	31/3/06 Actual £m	31/3/07 Previous Estimate £m	31/3/07 Latest Projection £m	**31/3/08 Estimate £m**	**31/3/09 Estimate £m**	**31/3/10 Estimate £m**
HRA	586	599	601	**614**	**626**	**638**
General Fund	97	137	106	**116**	**123**	**130**
Total	683	736	707	**730**	**749**	**768**

INDICATOR FIVE: ACTUAL DEBT- THE AUTHORISED AND OPERATIONAL LIMITS

Extract from Prudential Code

> *The local authority will set for the forthcoming financial year and the following two financial years an authorised limit and an operational boundary for its total external debt, gross of investments, separately identifying borrowing from other long-term liabilities.*

Comment and Recommended Indicator

These two limits are the limit on debt and long term liabilities outstanding on any one day. The lower limit is the operational boundary and takes account of ordinary activity. The authorised limit is the higher limit to accommodate unexpected borrowing that may be needed for very short periods. The total authorised limit is the limit councils have to determine under the Local Government Act 2003.

The average level of borrowing in any one year is usually close to the capital financing requirement. However on any one day borrowing may be higher or lower depending on cash flow movements and timing of borrowing decisions. When rates are expected to rise it is generally more attractive to borrow ahead of capital spending. There may also, in the future, be a benefit from borrowing additional funds over a short period to restructure debt by replacing high rate loans with lower rate ones. At the end of 2005/06 the Council had £694 million in outstanding borrowing. Since then no new loans have been taken on except for the £23m towards the December 2006 (and extinguished in January) for cash flow purposes.

The following limits are recommended for approval for 2007/08 to 2009/10. They are based on percentages added to capital financing requirements and should:

- accommodate existing borrowing,
- permit new investment, reflecting growth in capital financing and
- take on temporary borrowing for short period in a prudent and risk controlled framework without having the delay of a fresh re-determination (and risk compromising potential benefits in volatile markets)

PRUDENTIAL INDICATORS – RECOMMENDED FOR APPROVAL

Operational Boundary and Authorised Limits for External debt -	2005/06 Actual Max £m	2006/07 Previous Boundary/ Limit £m	2006/07 Latest Projection £m	**2007/08 Limit £m**	**2008/09 Limit £m**	**2009/10 Limit £m**
Operational Boundary for Debt						
Borrowing	694	806	717	800	820	840
Other long term liabilities	0	16	0	16	16	16
Total Operational	694	822	717	**816**	**836**	**856**
Authorised Limit for Debt -						
Borrowing	694	843	717	840	860	880
Other long term liabilities	0	17	0	17	17	17
Total Authorised	694	860	717	**857**	**877**	**897**

The Council has no long term liabilities at the moment, but the limit accommodates liabilities that may be taken in place of borrowing to finance assets.

Under existing arrangements, the Finance Director is responsible for all executive, strategic and operational borrowing decisions and has discretion to allow activity to go outside the operational boundary, should it be prudent and justified, but nevertheless remain within the overall authorised limit. The Finance Director may also vary the mix between long term liabilities and debt should it to be prudent to do so.

CRITERIA THREE: TREASURY MANAGEMENT

INDICATOR SIX: ADOPTION OF THE CIPFA TREASURY MANAGEMENT CODE OF PRACTICE.

Extract from Prudential Code

That the local authority has adopted the Treasury Management Code.

Comment and Recommended Indicator

This indicator confirms that the Council has adopted the code of practice for Treasury Management in the Public Sector issued by CIPFA and updated in 2002. At Southwark, the original code was adopted when it was first produced in 1992 and the latest version was adopted by the Council in February 2003. The Council Assembly is asked to confirm the continued adoption of the Code through the recommendations contained in this report.

INDICATOR SEVEN: INTEREST RATE EXPOSURES – FIXED
INDICATOR EIGHT: INTEREST RATE EXPOSURES - VARIABLE
INDICATOR NINE: MATURITIES

Extract from Prudential Code

The local authority will set for the forthcoming year and the following two financial years upper limits to its exposures to the effects of changes in interest rates. These prudential indicators will relate to both fixed and variable interest *rates. The local authority will set for the forthcoming year both upper and lower limits with respect to the maturity of its borrowing.*

Comment and Recommended Indicator

Council debt currently consists entirely of fixed rate loans, with very little falling for repayment over the next few years. However the proportion in fixed rates could change should financing conditions become favourable in the future. The fixed and variable rate limits reflect growth in capital financing requirement and the related authorised debt limit. The maturity limit reflects existing debt structure, with leeway to accommodate prudent refinancing.

LIMITS ON FIXED AND VARIABLE RATES	2005/06 Maximum Actual £m	2006/07 Previous Limit £m	2006/07 Latest Projection £m	**2007/08 Limit £m**	**2008/09 Limit £m**	**2009/10 Limit £m**
Upper limit for fixed interest rate exposure	694	843	717	**840**	**860**	**880**
Upper limit for variable rate exposure	0	210	0	**210**	**215**	**220**

Maturity structure of fixed rate borrowing	2005/06 Actual	2006/07 Upper Limit	2006/07 Lower Limit	2006/07 Latest Projection	**2007/08 Upper Limit**	**2007/08 Lower Limit**
under 12 months	0%	25%	0%	0%	**25%**	**0%**
12 months and within 24 months	0%	25%	0%	0%	**30%**	**0%**
24 months and within 5 years	11%	60%	0%	21%	**60%**	**0%**
5 years and within 10 years	38%	80%	0%	39%	**80%**	**0%**
10 years and above	51%	80%	0%	40%	**80%**	**0%**

INDICATOR TEN: TOTAL PRINCIPAL SUMS INVESTED FOR PERIODS LONGER THAN 364 DAYS.

Extract from Prudential Code

Where a local authority invests, for periods longer than 364 days, the local authority will set an upper limit for each forward financial year period for the maturing of such investments.

Comment and Recommended Indicator

The Council's cash balances averaged £302 million over the course of 2005/06 and as at the end of December 2006 stood at £323 million. The cash is invested across a number of counterparties which can include the Government, local authorities, and large high rated banks and building societies. Investment risk is further contained by placing limits on maturities that exceed one year. To capitalise on the benefits of generally stable base rates, investments in 2006/07 to date have mostly all been in deposits of up to one year. However it could be attractive to allow longer exposure should financial conditions prove favourable. The 2007/08 upper limit on exposure beyond one year has been raised to reflect the expanded investment options set out in the Investment Strategy. The limit will help the Council take advantage of favourable movements in rates whilst maintaining security.

Upper limit on investments greater than 1 yr	2005/06	2006/07	2006/07	**2007/08**
Upper limit / Actual	Actual max exposure 1-5 years: £11m 5-10 years: £0 m	Limits 1-5 years: £50m 5-10 years: £20m	Latest Projection 1-5 years £12 m 5-10 years £0 m	**Up to 50% of investments. Overall average maturity 3 years, but any one investment may be longer as referred to in the Annual Investment Strategy**

APPENDIX B

ANNUAL INVESTMENT STRATEGY 2007/08 - RECOMMENDED FOR APPROVAL

ANNUAL INVESTMENT STRATEGY 2007/08

1 INVESTMENT OBJECTIVES

1.1 The Council's investment objectives are to preserve principal, provide liquidity and secure a reasonable return. Cash investments may only be placed with specified and non-specified investments, which shall at all times be managed prudently.

1.2 Specified investments, as detailed below, are investments up to 1 year with high liquidity and credit qualities. Non-specified investments, as set out below, are investments that exceed 1 year and so potentially more responsive to liquidity, credit, and market factors. Prudent exposure to non-specified investments helps raise the level and sources of investment returns over the long term.

1.3 The Finance Director is responsible for this strategy and its management. External specialists and fund managers shall assist in advising or executing elements of the strategy.

2 CREDIT REQUIREMENTS

2.1 Credit risk arises where sums are placed with institutions (an issuer of investments) other than the UK Government or UK local authorities. It is the risk that the institution with whom investments are held fails to meet its obligations to investors. To contain exposure to this risk, reference shall be made to the following ratings, which are considered high and above the minimum regarded as investment grade by ratings agencies and indicate a low risk of default.

a) Issuer and Issue Rating

Issuer and Issue Rating Rating Agency	Minimum Short Term Rating	Minimum Long Term Rating	Maximum exposure up to 1 year £m	Maximum exposure 1 year to 5 years £m
Fitch Ratings	Issuer: F1+ Issue: F1	Issuer AA- Issue: A-	40	30
Moody's Investor Services	Issuer:P1 Issue: P1	Issuer: Aa3 Issue: A3	40	30
Standard & Poor's	Issuer:A-1+ Issue: A1	Issuer: AA- Issue: A-	40	30
Fitch Ratings	Issuer: F1	Issuer: A+	20	0
Moody's Investor Services	Issuer: P1	Issuer: A1	20	0
Standard & Poor's	Issuer: A1	Issuer: A+	20	0

b) Fund Ratings

ANNUAL INVESTMENT STRATEGY 2007/08 - RECOMMENDED FOR APPROVAL

Fund Rating Rating Agency	**Minimum Short Term Rating**	**Minimum Fund Value £m**	**Maximum exposure £m**
Fitch Ratings	AAA	1000	50
Moody's Investor Services	Aaa	1000	50
Standard & Poor's	AAA	1000	50
Fitch Ratings	A+	200	Up to 10% of fund value max £25 m
Moody's Investor Services	A1	200	Up to 10% of fund value max £25 m
Standard & Poor's	A+	200	Max of up to 10% of fund value max £25 m

2.2 Funds that are not separately rated may be considered where investments that make up the fund meet the minimum issue rating set out in the table above.

2.3 Ratings shall be reviewed at least twice a year. In the event of adverse rating changes, investments may be recalled prior to maturity where it would be prudent to do so.

2.4 Exposure to any one institution shall be diversified as is consistent with securing a reasonable return.

2.5 Credit requirements shall not apply to UK Government investments or local authorities, as neither is regarded as having credit risk.

2.6 There shall be no upper limit on exposure to the UK Government for credit risk purposes and the limit on exposure to any one local authority shall be £40m. Exposure to National Westminster Bank/ the Royal Bank of Scotland or HSBC Bank may be exceeded if it is necessary to be fully invested in the short term.

2.7 The Finance Director shall have discretion to vary the minimum rating or limits as appropriate to market conditions or developments where prudent.

3 OVERALL LIQUIDITY AND MATURITY CONSTRAINTS

3.1 The first call on investments shall usually be cash flow requirements and normally not less than £60m shall be held in maturities up to 1 year.

3.2 Overall investments shall only have a low or low to moderately low sensitivity to market factors. As a guide, the average maturity of investments shall be below 3 years.

4 SPECIFIED INVESTMENTS

ANNUAL INVESTMENT STRATEGY 2007/08 - RECOMMENDED FOR APPROVAL

4.1 Specified investments shall consist of the following categories of investments, subject to being denominated in sterling, meeting credit requirements set out above and not exceeding 1 year.

Specified Investments - in Sterling, meeting credit requirements and not beyond 1 year	
A	Bonds, bills, term deposits and accounts with the UK Government or UK Local Authorities
B	Fixed term deposits, accounts, certificates of deposits, commercial paper and senior unsubordinated notes and bonds with banks and UK building societies
C	Money Market Funds with stable asset values

4.2 These specified investments have high capital preservation and liquidity characteristics, and as such there shall be no upper limit on sums held in them. However investment requirements and market conditions may justify prudent exposure to longer term investments or other non-specified investments.

5 NON-SPECIFIED INVESTMENTS

5.1 Non specified investments shall consist of the following categories of investments, which shall be in sterling and meet applicable credit requirements.

Non-Specified Investments – maturities beyond 1 year, in Sterling and meeting credit requirements	
A	Bonds issued by the UK Government or Supranational bodies
B	Fixed term deposits and certificates of deposits with banks and UK building societies
C	Senior unsubordinated bonds and notes issued by banks and UK building societies
D	Principal protected structured deposits or notes
E	Bond funds

5.2 Categories C, D and E are additional to previous year's Investment Strategy and have been added to manage investment risk and diversify sources of investment returns. Details concerning the use, characteristics and limits applying to non-specified investments are set our below. The upper limit on exposure to non-specified investments as a whole shall be 50% of all investments. Overall liquidity, market and 3 year average constraints shall also be observed.

Non specified Investments- Usage, Characteristics and Limits	
A	**Bonds issued by the UK Government or Supranational bodies** *i) Typical usage* - To capture additional yields that may be available from investing longer from time to time, or - To benefit from short and long run rate expectations. *ii) Characteristics*

	- These bonds are highly liquid and of high credit quality, however prices are sensitive to expectations about the future course of interest rates, inflation and financial conditions generally. As well as moving favourably, prices can move adversely, risking income – the longer the bond the more sensitive its price to these factors. But the principal is protected if held to maturity. Limits are placed to contain exposure to this risk and positions are managed through external fund managers or with assistance from consultants. *iii) Limits* - No more than 50% of investments shall be placed in this category nor shall the maturity on any one bond exceed 10 years or the equivalent benchmark. No maturity limit applies to index linked or variable rate bonds.
B	**Fixed term deposits and certificates of deposits with banks and UK building societies** *i) Typical usage* - To capture additional yields that may be available from investing longer from time to time, - To protect investments from falling rates over the long term, or - To secure a given return over the long term. *ii) Characteristics* - These certificates of deposits are not as liquid as shorter issues and fixed term deposits are not liquid at all. Yields tend to be better than bonds and credit quality is high. As with longer bonds, the value of these investments is sensitive to market conditions, but principal is protected if held to maturity. Limits are placed to contain illiquidity. *iii) Limits* - No more than 50% of investments shall be placed in this category and no one investment shall exceed 5 years in maturity.
C	**Senior unsubordinated bonds and notes issued by banks and UK building societies.** *i) Typical usage* - To capture additional yields that may be available from investing longer from time to time,

	- To secure a pick up in yields above equivalent maturity fixed term deposits, or - To benefit from short and long run rate expectations. *ii) Characteristics* - Investments in this category are issued by the highest rated banks, but individual investments (issues) may rank lower in the credit hierarchy, but nevertheless still be of investment grade. Issues are liquid and yields are better than equivalent deposits. Principal is protected where held to maturity. These investments are managed through external managers or with assistance from consultants. Limits are placed to contain overall credit exposure. *iii) Limits* - No more than 50% of investments shall be placed in this category and no one investment shall exceed 5 years in maturity.
D	**Principal protected structured deposits or notes** *i) Typical usage* - To hedge returns across all investments, - To target returns from a particular course of interest rates where prudent, or - To diversify investment returns away from interest rate markets and into other financial markets where prudent. *ii) Characteristics* - Investments in this category are not liquid and returns are based on a particular course of interest rates or an index tied to particular financial markets (for example stocks, commodities and foreign exchange). The deposit or note provides the principal security and the return is provided using derivative overlays. Taken together the deposit or note is regarded as an investment, rather than a derivative in its own right. - The return is specific to particular characteristics within the investment and sensitive to whichever index it is based on. It may further depend on the value of any early termination options that may be associated with it. Principal is protected when held to maturity, but exposed to loss if cancelled prematurely. - This category of investment for the local authority market is

	only just beginning to develop and as returns are particular to each investment and sensitive to market conditions, specialist scenario analysis and tight limits are appropriate. *iii) Limits* - Exposure to structured deposits or notes should not exceed 10% of overall portfolio. - The maximum maturity on any one investment shall not exceed 5 years. - Additional prudential limits shall be determined as appropriate to particular investments following scenarios analysis.
E	**Bond funds** *i) Typical usage* - To access the wider range of investments and strategies that funds participate in, - To enhance returns over the longer term, or - To diversify investment and credit risk in overall investments. *ii) Characteristics* - Funds typically consist of investment grade corporate and financial institution debt and structured products. Exposure to anyone counterparty is kept low and the wide range of credit rating and strategies available to funds helps raise returns over the longer term. - In addition to credit characteristics, funds may be distinguished according to volatility. The lower the average maturity of investment, the lower the volatility and the higher the short run capital preservation characteristics. However funds may require a longer time frame over which to enhance returns. Funds also have high liquidity. *iii) Limits* - No more than 50% of investments shall be placed in this category. - Funds should have a low or low to moderately low sensitivity to interest rate and market factors.