treasury management in the public services

guidance notes for
local authorities including
police ~~forces~~ bodies and fire
and rescue authorities
2021~~18~~ edition

TREASURY INDICATORS WITHIN THE PRUDENTIAL CODE

Authorised limit

The local authority will set for the forthcoming financial year and the following two financialyears an authorised limit for its total gross external debt, excluding investments, separately identifying borrowing from other long-term liabilities. This prudential indicator will be referred to as the authorised limit and shall be expressed in the following manner:

> Authorised limit for external debt = authorised limit for borrowing + authorised limit forother long-term liabilities.
>
> For years 1, 2 and 3.

Operational boundary

The local authority will also set for the forthcoming financial year and the following two financial years an operational boundary for its total external debt, excluding investments, separately identifying borrowing from other long-term liabilities. This prudential indicator willbe referred to as the operational boundary and shall be expressed in the following manner:

> Operational boundary for external debt = operational boundary for borrowing + operational boundary for other long-term liabilities.
>
> For years 1, 2 and 3.

Both the authorised limit and the operational boundary need to be consistent with the authority's plans for capital expenditure and financing and with its treasury managementpolicy statement and practices.

The operational boundary should be based on the authority's estimate of most likely scenario – prudent, but not worst-case. Risk analysis and risk management strategies should be takeninto account. The operational boundary should equate to the maximum level of external debtprojected by this estimate. Thus, the operational boundary links directly to the authority's plans for capital expenditure, its estimates of capital financing requirement and its estimate of cash flow requirements for the year for all purposes. The operational boundary is a key management tool for in-year monitoring as described in the Prudential Code:

It will probably not be significant if the operational boundary is breached temporarily on occasions due to variations in cash flow. However, a sustained or regular trend above the

operational boundary would be significant and should lead to further investigation and action as appropriate.

Thus, both the operational boundary and the authorised limit will be based on the authority's plans. The authority will need to assure itself that these plans are affordable and prudent. The authorised limit will in addition need to provide sufficient headroom over and above the operational boundary, for example for unusual cash movements.

Actual external debt

After the yeaend, the closing balance for actual gross borrowing plus (separately) other long-term liabilities will be obtained directly from the local authority's balance sheet. This prudential indicator will be referred to as actual external debt and shall be expressed in thefollowing manner:

> Actual external debt as at xx/xx/xx = actual borrowing as at xx/xx/xx + actual other long-term liabilities as at xx/xx/xx

The prudential indicator for actual external debt considers a single point in time and hence is only directly comparable to the authorised limit and operational boundary at that point in time. Actual external debt during the year can be compared with the authorised limit andoperational boundary.

Local indicators

Where local authorities have material residual liabilities, for example arising as a result of the establishment of combined authorities or residual liabilities arising from activities withina group structure, they may wish to use local indicators to improve understanding of their impact on overall borrowing levels. For example, a local authority may have a liability in respect of borrowing by a combined authority and may wish to set an operational boundary and/or authorised limit in respect of the combined authority which can be monitored againstthe actual liability.

Where local authorities have separately identifiable income streams that relate to borrowing for specific functions, they should consider setting an operational boundary or authorised limit in relation to these functions. Examples of functional limits would include borrowing bya mayoral combined authority in respect of the police and crime commissioner where there is a statutory requirement to maintain a police fund. Where an authority has a statutory
revenue account, eg the Housing Revenue Account (HRA), it should determine what additionalindicators are required and set local indicators to monitor borrowing in relation to that statutory account.

Local authorities may also wish to consider using local indicators where borrowing relates tospecific income streams to ensure that borrowing remains sustainable and either at a level that does not impact on general resources or that the impact on general resource remains at an acceptable level. Such income streams could include central government funding, commercial income or other external funding.

~~Where local indicators are used these can only be a subset of the local authority's overall operational boundary and authorised limit as all borrowing and liabilities remainthe responsibility of the authority. The Prudential Code sets out detailed governance~~

~~arrangements in relation to these indicators for the overall authority, where an authority sets local indicators it may choose to vary these arrangements for the local indicators only. Wheredifferent approval and monitoring arrangements apply for local indicators these should be clearly documented.~~

~~ADDITIONAL~~ TREASURY MANAGEMENT PRUDENTIAL INDICATORS ~~RELEVANT TO LOCAL AUTHORITIES~~

Liability benchmark

As a minimum, the local authority will estimate and measure the liability benchmark for the forthcoming financial year and the following two financial years. However, CIPFA strongly recommends that liability benchmark is produced for at least 10 years and should ideally cover the full debt maturity profile of a local authority: local authorities should have a strong grasp of both their existing debt maturity profile, and also of how MRP and other cashflows affect their future debt requirement.

The liability benchmark is not a single measure but should be presented as a chart of four balances as follows:

- Existing loan debt outstanding: the authority's existing loans which are still outstanding in future years. It may be helpful to present this part of the graph as a stacked bar chart showing fixed rate loans, variable rate loans and LOBOs separately.
- Loans CFR: calculated in accordance with the loans CFR definition in the Prudential Code, and projected into the future based on approved prudential borrowing and planned MRP taking account of approved prudential borrowing
- Net loans requirement: the authority's gross loan debt, less treasury management investments, at the last financial year end, projected into the future based on its approved prudential borrowing, planned MRP and any other forecast major cash flows
- Liability benchmark (or Gross Loans Requirement) = Net loans requirement + short term liquidity allowance

The authority may wish to produce a similar chart including forecast investments, particularly for authorities where future loan debt is greater than the loans requirement.

Short-term liquidity allowance means an adequate (but not excessive) allowance for a level of excess cash to be invested short term to provide access to liquidity if needed (due to short-term cash flow variations, for example).

This indicator is relevant for all authorities, including those with a net cash surplus. For such authorities it becomes a measure of the forecast net investment requirement, and guides the appropriate size and maturity of investments needed.

This indicator will be referred to as the prudential indicator for the liability benchmark.

-The liability benchmark should be analysed as part of the annual treasury management strategy, and any substantial mismatches between actual loan debt outstanding and the liability benchmark should be explained. Any years where actual loans are less than the benchmark indicate a future borrowing requirement; any years where actual loans outstanding exceed the benchmark represent an overborrowed position which will result in excess cash requiring investment (unless any currently unknown future borrowing plans increase the benchmark loan debt requirement). The treasury strategy should explain how the treasury risks inherent in these mismatched positions will be managed.

Maturity structure of borrowing

The local authority will set for the forthcoming financial year both upper and lower limits ~~withrespect to~~for the maturity structure of its borrowing. These prudential indicators will be referred to as the upper and lower limits ~~respectively~~ for the maturity structure of borrowing and shall be calculated as follows:

Amount of projected borrowing that is maturing in each period

Expressed as a percentage of:

Total projected borrowing

Where the periods in question are:

- under 12 months
- 12 months and within 24 months
- 24 months and within five years
- five years and within ten years
- ten years and above.

For many local authorities their borrowing is typically very long term, and so for many most of their borrowing will be in the 'ten years and above' maturity period. If this is the case, authorities should break down the period in excess of ten years into several ranges, if significant borrowing is held in those periods; eg ten to 20 years, 20 to 30 years.

~~The maturity of borrowing should be determined by reference to the earliest date on which the lender can require payment~~Lender's Option Borrower's Option loans (LOBOs) have an uncertain maturity date due to the potential option calls. LOBOs should be shown as maturing at their most probable option call date (which may not be their next option or final maturity date).

This indicator ~~has been changed from previous years and now~~ covers all borrowing, ie fixedand variable rate, and not just fixed rate borrowing.

The centre of the range for each of the maturity limits should logically be at the level shown by the liability benchmark, in order to match actual maturities to the authority's gross loans requirement. So if the liability benchmark shows that the authority's loans requirement reduces by 30% between years 5 to 10, then that should be the midpoint of the 5-10 year maturity limits (which could be say 20% to 40%). The wider the range, the more refinancing (and interest rate) risk the authority is accepting.

Revisions to limits on the maturity structure of borrowing

Where indicators for the maturity structure of borrowing are revised during the financial year,the time periods under 12 months/12 months and within 24 months, etc shall refer to the time periods within 12 months of the start of the financial year/from 12 months and within 24 months etc respectively.

~~Total~~ Long term treasury management investments ~~principal sums invested for periods longer than a year~~

Where a local authority invests, or plans to invest~~,~~ for treasury management purposes in fixed interest instruments for periods longer than a year, or in other instruments only appropriate for longer term investment, the localauthority will set an upper limit for each forward financial year period for the maturing ofsuch investments. These prudential indicators will be referred to as prudential limits for ~~principal~~ long term treasury management investments~~sums invested for periods longer than a year~~ and shall be calculated as follows:

Total principal sum invested to final maturities beyond the period end.

For years 1, 2, 3, etc.

Followed by the total amounts invested in longer term instruments with no fixed maturity date.

Longer term instruments with no fixed maturity date include pooled bond, equity and property funds (but not money market funds), as well as directly held equities. The intention is for this indicator to capture all the investments of a longer term nature which are being made for treasury management purposes.

The purpose of the prudential limits for principal sums invested for periods longer than a year is for the local authority to contain its exposure to the possibility of loss that might arise as a result of it having to borrow short term at higher rates or redeem investments at a loss~~seek early repayment or redemption of principal sums invested~~.

Interest rate exposures

There is no longer a specific recommended indicator in respect of interest rate exposures. ~~,instead a~~Authorities are asked to explain their strategy for managing interest rate risks as part of their capital/investment strategy. Authorities are encouraged to make full use of benchmarks and indicators in setting this strategy; in particular they may wish to show the impact of a 1% increase in interest rates over the three year plan period; this indicator is already required for the Financial Statements.

~~When setting the treasury strategy for interest rate exposures and the maturity structure of borrowing, local authorities are encouraged to start by defining their own 'liability benchmark' interest rate exposure and maturity profile position, and then setting limits which relate logically to that benchmark. The liability benchmark measures the authoritiesprojected net debt requirement plus a short term liquidity allowance for future periods. Thepurpose of a liability benchmark is to establish the level of risk which the authority regards as its balanced or normal position, so that it can take measured decisions about whether to be 'overweight' or 'underweight' in relation to that risk. This enables clearer management~~

~~of interest rate risks against the benchmark, rather than implying that any position within the upper and lower limits is equal in terms of risk.~~

~~Authorities may wish to report and agree the liability benchmark level as part of setting the prudential limits.~~

Credit risk

~~There is no specific recommended indicator in relation to credit risk.~~ **Authorities** are encouraged to~~may wish to~~ **design and set their own indicators in relation to this.** Authorities should consider settingindicators that identify the credit risk associated with the investment of surplus cash including cash in operational bank accounts.

Price risk

There is no specific indicator for price risk. Authorities with investments which are materially exposed to fluctuations in fair value should ensure that their reporting under the Prudential Code, Treasury Management Code and Statutory Investment Guidance includes an appropriate measure of price risk, and should report on movements in fair value in their reporting under the Codes and Guidance. This should be reported separately for treasury management and commercial investments and, where appropriate, for service investments.

TREASURY MANAGEMENT PRUDENTIAL INDICATORS - GUIDANCE

Liability benchmark

The liability benchmark is a measure of how well the existing loans portfolio matches the authority's planned borrowing needs. An example of a liability benchmark chart is shown below:

The key comparison is between the authority's forecast gross loan debt (the red benchmark line) and the existing loans portfolio which remain outstanding in future (the black line). If the black line is below the red line, the existing portfolio outstanding is less than the loan debt required, and the authority will need to borrow to meet the shortfall. If the black line is above the red line, the authority will (based on its current plans) have more debt than it needs, and the excess will have to be invested. The chart therefore tells an authority how much it needs to borrow, when, and to want maturities to match its planned borrowing needs.

Forecasting assumptions

These forecasts should be based on long term forecasts of the above four lines as follows:

Existing loan debt outstanding:

- the authority should show LOBO loan maturities at their most probable option call date (which may not be their next option or final maturity date).

Loans CFR:

- The Loans CFR excludes any part of the CFR related to Other Long Term Liabilities rather than borrowing
- Start from the last year end actual loans CFR
- Add the prudential borrowing in the authority's current capital programme (with no assumption for unknown future prudential borrowing not yet approved)
- Deduct MRP (and any material capital receipts used for debt redemption) based on the existing CFR plus the proposed capital programme
- Authorities are expected to be able to calculate their MRP and hence their CFR for the long term, and this should be for the whole life of the CFR.

Net loans requirement:

- This is a forecast of the authority's net loan debt, ie. net of investments for treasury management purposes
- It starts from the last year end's actual loan debt, less investments for treasury management purposes. It will then change in accordance with the authority's annual cashflow forecast:
- Plus or minus the increase or reduction in the CFR
- Plus or minus any material forecast non-CFR cashflows which are not taken into account in a balanced revenue budget assumption. Examples of major cashflows might be the use of (or addition to) reserves (including the capital receipts reserve), or a three year pension fund advance payment (which would be an increased cashflow out in year 1 and a reduced cashflow in years 2 and 3).
- A cashflow forecast like this is likely to broadly perpetuate any existing gap between the authority's actual net loan debt and its CFR. This is a reasonable baseline planning assumption: unless something changes structurally in the basis of local government finance, authorities are likely to run a working capital surplus which means that they are unlikely to need to borrow as much as their CFR. Alternative sensitivities can always be tested. Good cashflow forecasting, especially over the medium term financial plan period (say four or five years), is fundamental to treasury budgeting. Treasury managers need to maintain a close awareness of cashflow implications of unusual major transactions (say, a three year pension fund advance payment) in order to forecast debt requirements properly.
- A key point is that these cashflows represent the authority's non-treasury cashflows, ignoring any decisions to borrow in advance or use investments. It represents the level of loan debt needed to fund the authority's plans, prior to any treasury action. Comparing it with the actual loans portfolio identifies the amount of new borrowing needed.

The Liability Benchmark (Gross Loans Requirement):

- This is a forecast of the authority's gross loan debt
- It starts from the forecast Net Loans Requirement in each year
- then adds a liquidity allowance for treasury management investments, to produce the level of gross loan debt the authority will need to have in future years. The liquidity allowance is an estimate of the level of short term investments needed to provide an adequate (but not excessive) level of liquidity for daily cashflow management. It is recognized that the year end position which the chart measures may not be a typical position during the year, so actual short term investments in-year may often be higher than the year end allowance.

The forecasting data for the example shown above is as follows (first ten years):

Data for Combo chart showing stacked debt (£m's)											
years from last actuals	**op bals**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Existing Long term debt - fixed rate	65	65	62	62	62	60	60	60	60	60	58
Existing LOBO	15	15	15	15	15	15	15	15	15	15	15
Existing short term & variable rate	10	5	5	0	0	0	0	0	0	0	0
= existing loan debt outstanding	**90**	**85**	**82**	**77**	**77**	**75**	**75**	**75**	**75**	**75**	**73**
opening loan debt	90										
less opening treasury investments	-5										
plus planned prudential borrowing		7	5	3	2						
less MRP & cap receipts set aside		-3	-3	-3	-3	-3	-3	-3	-3	-3	-3
+/- other forecast cashflows			2	-3	1						
= forecast net loan debt (net loans requirement)	**85**	**89**	**93**	**90**	**90**	**86**	**83**	**80**	**78**	**75**	**72**
opening loans CFR	100										
plus planned prudential borrowing		7	5	3	2	0	0	0	0	0	0
less MRP & cap receipts set aside		-3	-3	-3	-3	-3	-3	-3	-3	-3	-3
Loans CFR	**100**	**104**	**106**	**106**	**105**	**101**	**98**	**95**	**93**	**90**	**87**
liquidity allowance above net debt	5	5	5	5	5	5	5	5	5	5	5
Gross loans requiremt (benchmk)	**90**	**94**	**98**	**95**	**95**	**91**	**88**	**85**	**83**	**80**	**77**
forecast investments	5	5	5	5	5	5	5	5	5	5	5

Authorities are recommended to use their own spreadsheet to produce the liability benchmark chart, and should not rely on their advisors to produce it. It can be as simple as the table above. This will enable authorities to own their own cashflow and debt forecasts as part of their medium and long term financial planning process. The liability benchmark is not just an annual exercise in order to produce the prudential indicators; it is a live tool to enable authorities to identify their new borrowing requirement and the maturities at which new borrowing should be taken to match their future debt requirement and to minimize their treasury risks. It should be a key consideration each time an authority considers long term borrowing, in terms of how much and to what maturity. It should therefore be part of the audit trail justifying long term borrowing decisions. It will need to be updated following new long term borrowing in order to identify the revised borrowing requirement.

Authorities with an HRA or other statutory account with borrowing may wish to produce a separate liability benchmark for the HRA and the General Fund. This would enable them to be clear about the maturities required for each Fund, which might be significantly different depending on the MRP / repayment policies for each Fund.

Liability benchmark – use and interpretation

The liability benchmark is a projection of the amount of loan debt outstanding which the authority needs each year into the future, in order to fund its existing debt liabilities, planned prudential borrowing and other cashflows.

This is shown by the gap between the authority's existing loans which are still outstanding at a given future date, and the authority's future need for borrowing (as shown by the liability benchmark).

It therefore shows how closely the existing loans book fits the future needs of the authority based only on its current plans. Any shortfall will need to be met by future borrowing; any excess will have to be invested (unless existing borrowing is prematurely repaid). Refinancing risk, interest rate risk and credit risk can be minimized or reduced by ensuring that the existing loans portfolio shows a profile close to the liability benchmark.

In particular, the liability benchmark identifies the maturities needed for new borrowing, in order to match future liabilities. It therefore avoids borrowing for too long or too short. Local authorities have sometimes used the CFR as their benchmark of borrowing needs, but this is likely to result in substantial over-borrowing because authorities generally have systemic in-hand cashflows and balances which keep actual debt (net of treasury investments) well below the CFR. Borrowing needs are based on cashflows, not the CFR – accepting the need for a reasonable but not excessive holding of short term investments for liquidity management.

The liability benchmark makes no assumption about the level of future prudential borrowing in as yet unknown capital budgets. This avoids making large assumptions which may prove to be spectacularly wrong; but the main reason is that it enables the benchmark to be compared like-for-life with the existing loans portfolio to identify the future borrowing and investment needs arising from the authority's existing plans. It shows us what the current debt maturity profile should be to match the authority's current borrowing commitments less MRP and other forecast cashflows. Matching the portfolio to the need minimises treasury risks.

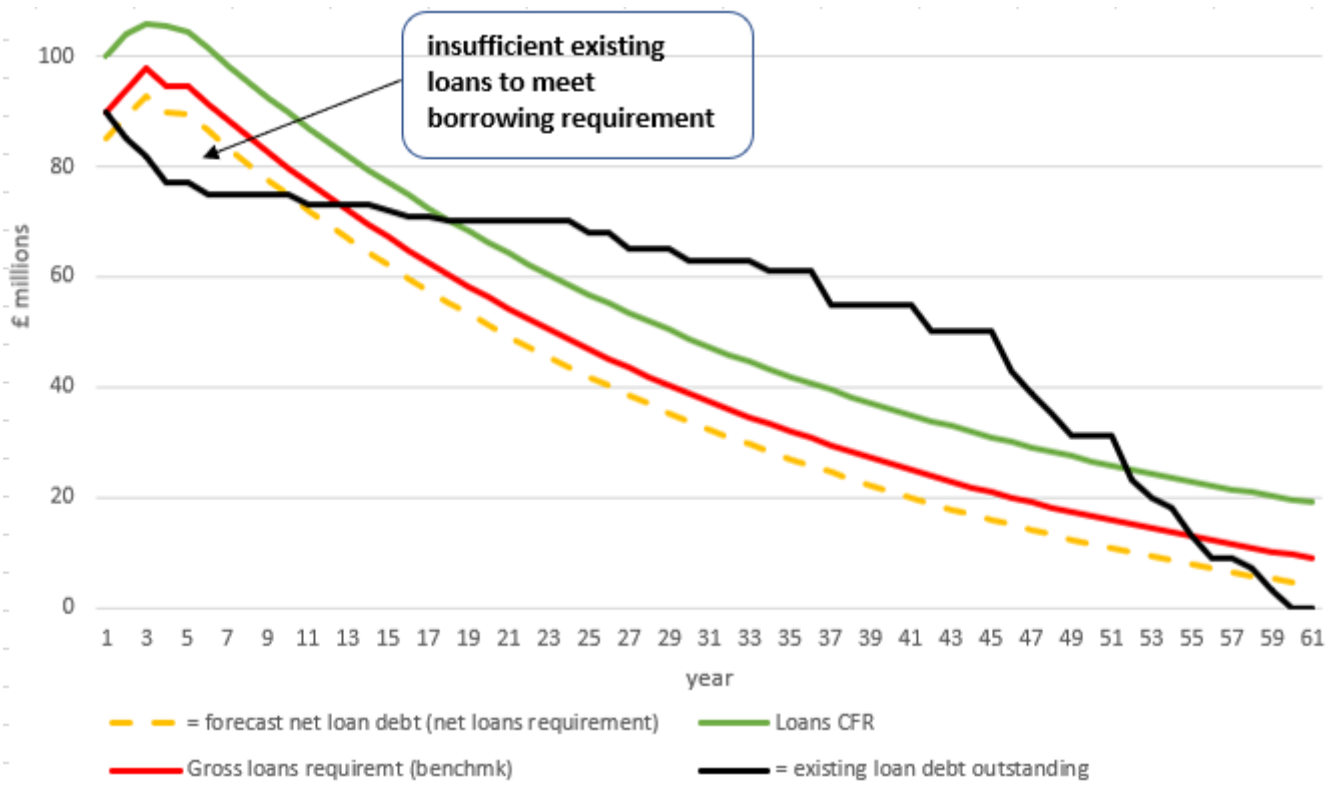
The liability benchmark is in the first instance a measure of financing or refinancing risk. However, it can also be used to show interest rate risk, by dividing the existing loan debt outstanding into fixed rate, variable rate and LOBO components. The gap between the existing loans portfolio and the liability benchmark is by default a measure of future variable rate risk (unless the authority takes fixed rate borrowing to fund it).

The liability benchmark is a long term forecast of the authority's gross loan debt (or 'gross loans requirement') based on its current capital programme and other forecast cashflow movements. In many authorities it may therefore be the same figure as the Operational Boundary for loans in the Prudential Code, which is also an estimate of the most likely scenario consistent with the authority's current plans. However, if the authority has borrowed in advance of need (or for whatever reason has more loans outstanding than it currently needs), then its actual loans outstanding and its Operational Boundary will be higher than its liability benchmark. The difference will represent the excess borrowing, resulting in a level of treasury investments in excess of a reasonable allowance for liquidity. In this scenario, the treasury management strategy should explain the reasons for the excess debt and how long that position is expected to last.

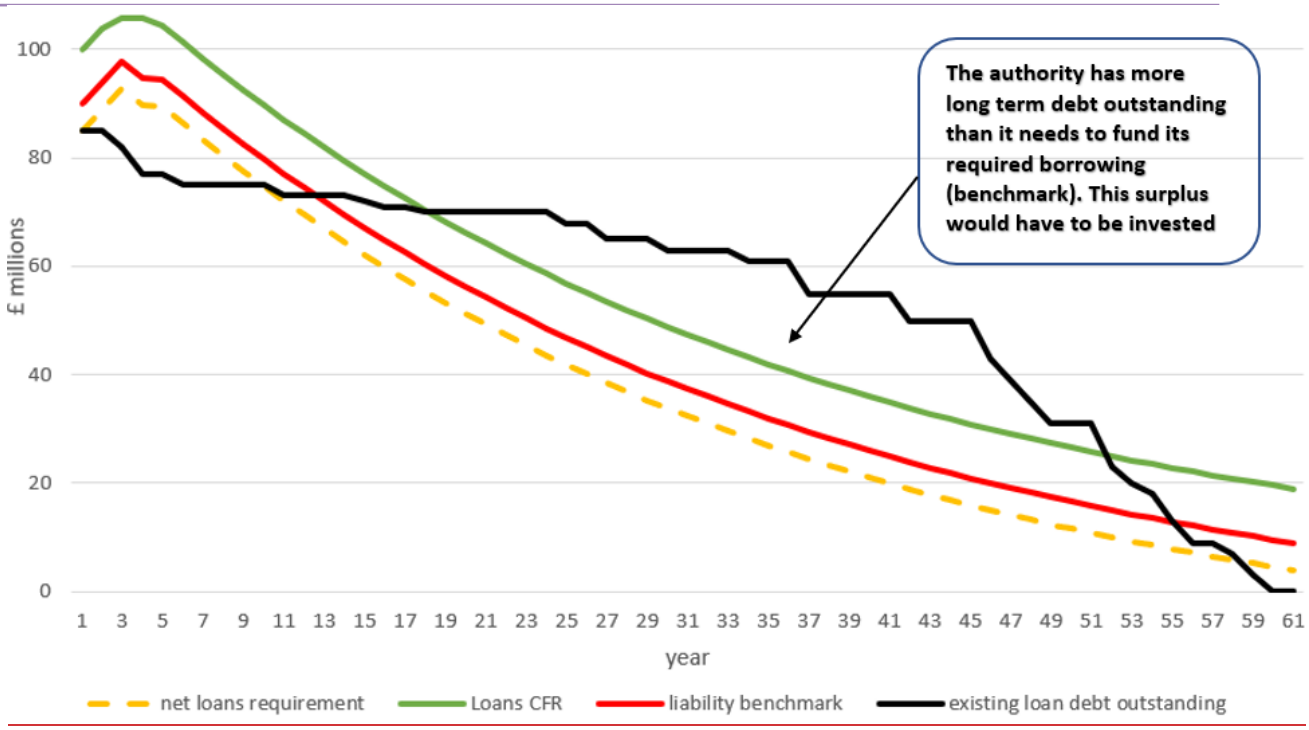
Liability benchmark: example

The authority in the example shown above starts off with growing debt due to prudential borrowing in its capital programme. At the same time, its existing loans outstanding are reducing due to loan maturities. This means that it has insufficient existing loan debt to meet the borrowing

requirements of the next twelve years or so. The black line showing existing loans outstanding is below the red (benchmark) line, which represents the gross loan debt the authority expects to need to fund its existing plans:



However the position reverses after year twelve. The authority has in the past taken predominantly long term loans, which do not mature as fast as the annual MRP reduces the authority's required borrowing. The black line (actual debt) becomes significantly higher than the red line (required debt). The excess debt will be surplus cash that will have to be invested, resulting in unnecessary credit risk and potentially significant loss between the cost of the borrowing and the interest received on reinvestment:

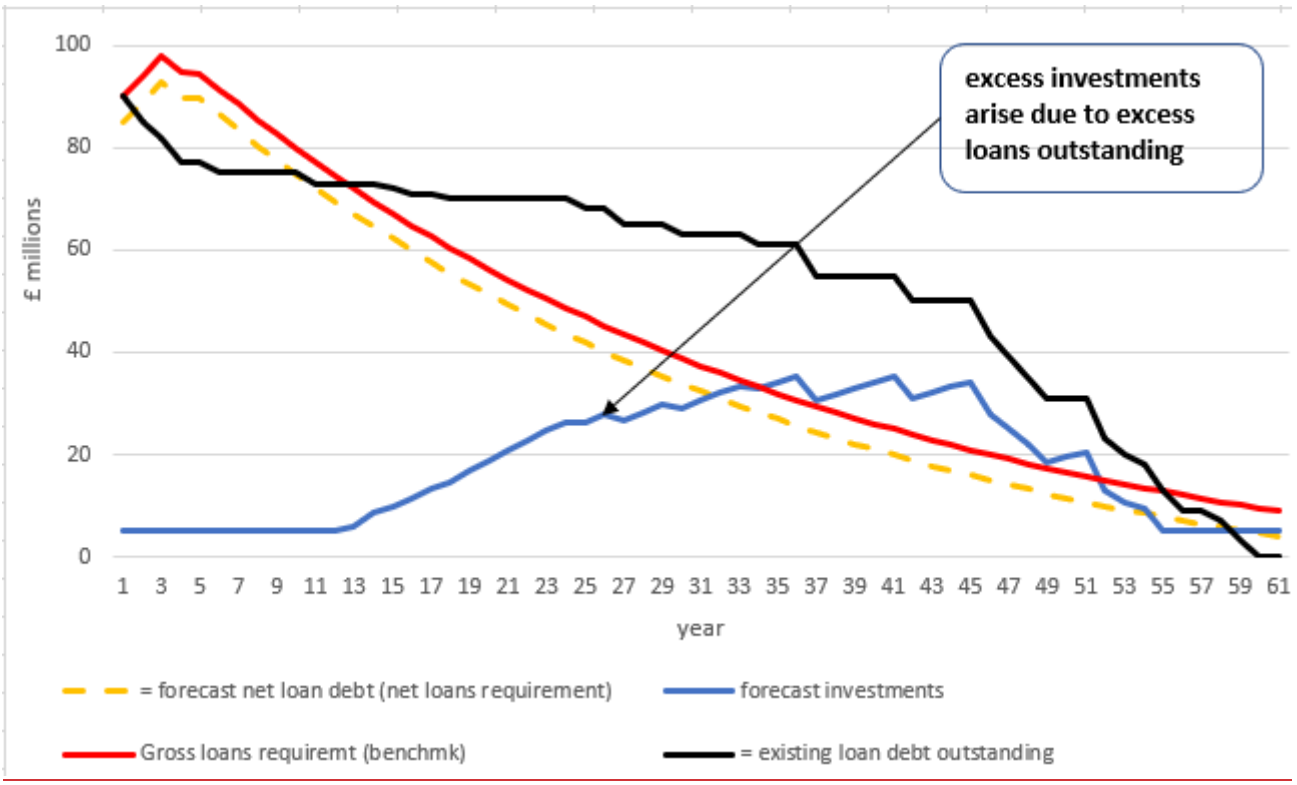


The cashflow projection for this authority results in its net loan debt (orange dotted line) remaining well below its loans CFR (green line). This is typical of local authorities, and the CFR should not be used as a proxy for forecast net loan debt. In this example, the authority would actually breach the Prudential Code's requirement that Gross debt remains below the CFR, unless future as yet unknown borrowing plans increase its borrowing requirement substantially. The authority is in this position because its existing maturity profile does not reduce as quickly as its MRP reduces its CFR.

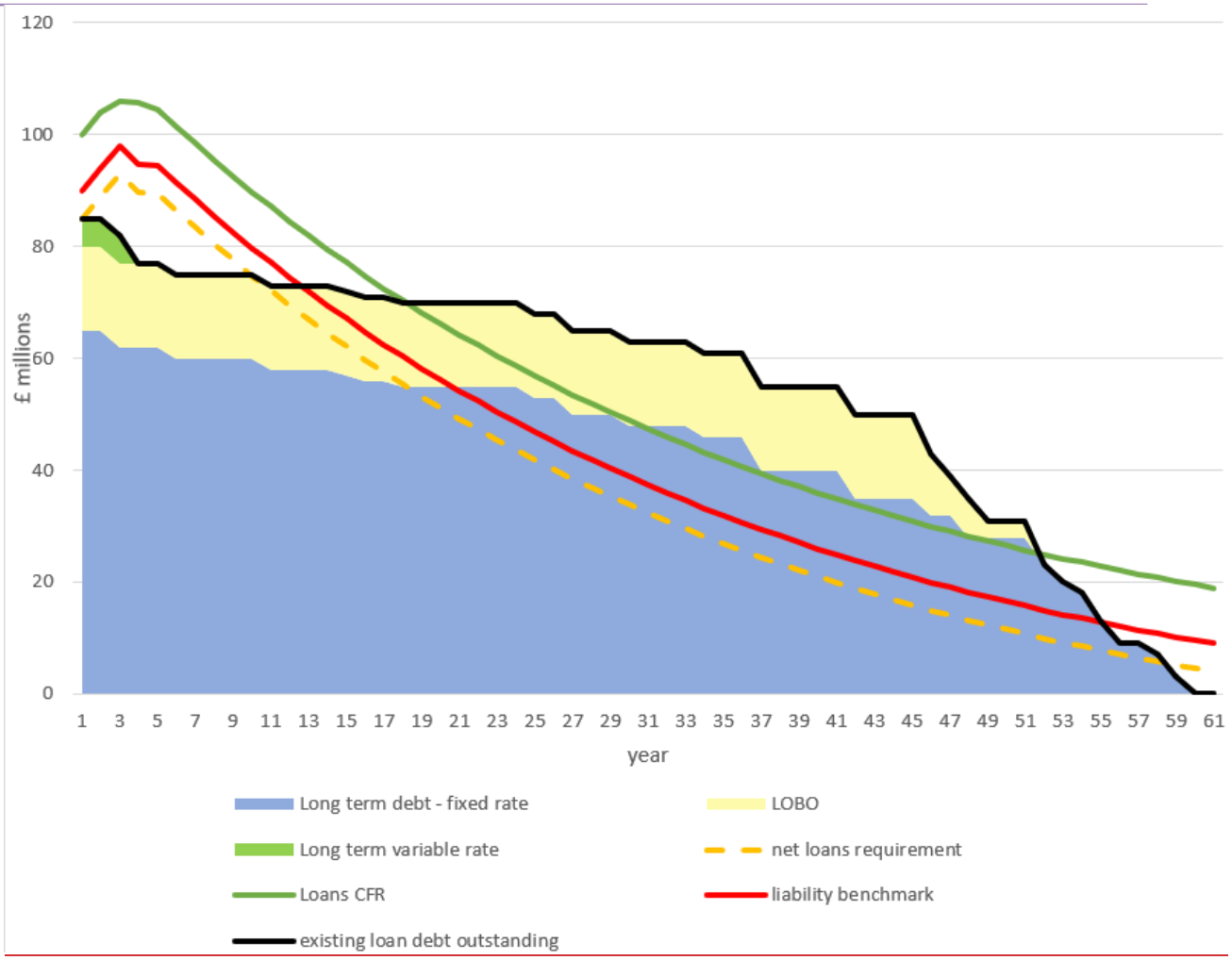
It may be that the authority's future budgets will include new prudential borrowing such that its projected surplus debt will be needed. But we don't know the future, and we can't say what new borrowing the authority will decide is prudent (or whether the future capital controls will permit that much capital expenditure). The authority has in effect borrowed substantially in advance of an assumed future need which is as yet unknown. The prudent approach is to match its loan maturity profile to the authority's current plans and MRP repayment profile.

The funding gap or funding surplus can therefore be used to guide the amount and maturity of all new long term borrowing. This authority's borrowing requirement only lasts for 12 years. If in this period it takes loans with a maturity of more than 12 years, it risks increasing its excess debt portfolio in later years resulting in surplus cash requiring investment. The borrowing that it takes in the next few years should therefore be at relatively short maturities up to 12 years, in order to fill the gap and (approximately) match the red line requirement. Authorities should refer to their current benchmark shortfall / surplus position every time they borrow long term, in order to justify the maturity period which they are proposing. It is part of new borrowing due dili~~l~~gence. The costs of borrowing for too long could be substantial: ongoing interest costs only partly offset by interest receivable, plus the credit risks attached to the investment of the excess cash.

The data table can show the amount of excess cash requiring investment. Authorities may prefer the chart to show the investment line (blue in this example):



The charts so far have only shown refinancing risk. However, the chart can readily show interest risk also by analysing the existing loan debt outstanding into the main interest rate risk components, such as fixed rate loans, long term variable rate loans, and LOBOs:



This hypothetical authority has quite a significant LOBO loan book, which adds significant uncertainty both to its maturity profile and to its interest cost stability. If the LOBOs are called earlier than assumed (and the authority decides to repay), its future debt would shrink (which given the extent of its long term over-borrowing, might well be helpful).

'Net book' management

The premise underlying the liability benchmark, the definition of treasury management investments and the Prudential and Treasury Codes' approach to commercial investments is that local authorities should normally run a 'net book' treasury management position. In other words, authorities should:

- net down their borrowing and investments in order to minimize the treasury risks resulting from running debt and investment portfolios at the same time;
- integrate the management of their borrowing and investments, reviewing them together when monitoring and managing treasury risks.

A 'net book' approach nets down borrowing and investments in order to avoid such unnecessary risks and activities. However, it is prudent to allow for some short term investments in order to manage liquidity risks; this is the 'liquidity allowance' which is taken into account when forecasting the authority's gross loans requirement (ie the forecast gross loan debt required to fund the

authority's plans).

Appendix 3 considers these issues in relation to investments for commercial purposes. The Prudential Code and this Code emphasise that an authority must not borrow to invest for the primary purpose of financial return. Such 'leveraged' investments add unnecessary risk by grossing up borrowing and investments rather than netting them down. It is CIPFA's view that throughout the public services the priority for treasury management is to protect capital rather than to maximise return. The magnified risks of leveraged investments, and the fact that they put public money at unnecessary risk, mean that borrowing in order to invest for the primary purpose of earning a return is not in CIPFA's view a prudent use of public funds.

Maturity structure of borrowing

This indicator is closely related to the liability benchmark, which provides a projection of future debt outstanding around which to set the upper and lower limits for each maturity range. Authorities have historically sought to spread their debt maturities, in order to manage refinancing risk and interest rate risk. However, without the liability benchmark's forecast of debt outstanding based on existing debt and current plans only, it is impossible to know what maturity profile to aim for. The liability benchmark provides the methodology for producing maturity ranges appropriate to the authority's own committed borrowing profile.

For example, if the liability benchmark shows that the authority's gross loans requirement reduces by 30% between years 5 to 10, then that should be the midpoint of the 5-10 year maturity limits (which could be say 20% to 40%. In practice, the liability benchmark is mainly derived from the MRP, and so all other things being equal, the benchmark level of maturities in years 5-10 should normally equal cumulative MRP in years 5-10.

Long term treasury management investments

The scope of this indicator has been clarified to relate explicitly to the authority's investments for treasury management purposes. Investments taken or held for service purposes or commercial purposes should not be included in this indicator (these investment purposes are defined in the Prudential Code's Definitions section and in section 8 of the Treasury Management Code).

This indicator has been changed in the 2021 Code to include not just fixed rate investments with maturities of over 1 year, but also other investments of a long term nature with no fixed maturity. The intention is to capture all treasury management investments other than short term deposits and money market funds. This should therefore be the same as the non-specified investments in the MHCLG Investment Guidance (3rd edition) which are held for treasury management purposes (theoretically, authorities might have short term treasury management investments which are non-specified because they are not of 'high credit quality', but it is not expected that authorities would have any of these in practice). The Investment Guidance requires authorities to set limits for appropriate categories of non- specified investments, so the

Code's limit for long term investments should also address the MCHLG requirement in respect of non-specified treasury management investments (authorities holding non-specified investments for commercial or service purposes will need to approve limits for these too).

~~In all cases, t~~The process of setting prudential indicators for treasury management should be led by a clear and integrated forward treasury management strategy, and recognition of the pre-existing structure of the authority's borrowing and investment portfolios.

The prime policy objectives of local authority investment activities are the security and liquidity of funds, and authorities should avoid exposing public funds to unnecessary or unquantified risk. Authorities should consider the return on their investments; however, this should not be at the expense of security and liquidity. It is therefore important that authorities adopt an appropriate approach to risk management with regards to their investment activities. ~~Authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed~~ Organisations must not borrow earlier than required to meet cashflow needs unless there is a clear business case for doing so, and must only do so for the current capital programme, to finance future debt maturities, or to ensure an adequate level of short term investments to provide liquidity for the organisation (TMP1 liquidity risk).

Authorities shouldalso consider carefully whether they can demonstrate value for money in borrowing in advance of need and can ensure the security of such funds. These principles should be bornein mind when investments are made, particularly for the medium to long term.

Interest rate exposures

The Code requires each authority to set out its strategy for managing interest rate risks with such indicators as are appropriate. The indicators used should cover at least the forthcoming year and the following two years, in line with other prudential indicators. Authorities may find it helpful to use the measure required for the Financial Statements, which sets out the cost of a 1% increase in interest rates.

Authorities may also use more advanced techniques such as Monte Carlo simulations to show the future uncertainty in revenue budgets arising from interest rate risk.

The liability benchmark chart can readily be used to portray interest rate risk, by splitting existing loans outstanding into its interest risk characteristics, eg fixed rate loans, variable rate loans, and LOBOs.

Credit risk

Authorities are asked to consider credit risk indicators appropriate to themselves. One simple measure which some authorities use is an overall credit score, ie the weighted average credit rating of the authority's treasury management investments.

Price risk

Authorities are asked to ensure that their reporting of investments which are materially exposed to movements in fair value includes an appropriate measure of price risk and reporting on movements

in fair value.

This reporting should be done as part of reporting on all the authority's investments as categorised by the authority between investments for treasury management, commercial, and service purposes.

Fair value information at year ends should be consistent with the information in the Financial Statements. Reporting fair value at other points during the year can use quoted market prices where available, but fair value reporting will be constrained for some investments by what information is reasonably available in practice – especially service investments.

'Investments' in the Code includes commercial property. Authorities with commercial property portfolios should establish a view of fair value at each year end. This is required in any case for the investment risk indicators and reporting under the Statutory Investment Guidance.