Agenda Item No. 7 (d)

Title: **Treasury Management Strategy Report**

Portfolio Holder: **Cllr Carbin – Finance & Policy Portfolio Holder**

Reporting officer: **Andy Brown – Financial Accountant**

Purpose

This report seeks Council approval for the prudential indicators for 2007/08 to 2009/10 and the Treasury Strategy 2007/08 agreed by Cabinet at its meeting of 7 February 2007 and recommended to Council. This report sets out the strategy to be pursued in the coming financial year and includes the Investment Strategy.

Background

This report and associated documents has been prepared in accordance with the following guidance and advice from Butlers, the Council's external treasury management advisers.

- The reporting of the Prudential Indicators as required by the CIPFA Prudential Code for Capital Finance in Local Authorities, Appendix A.
- The Treasury Strategy in accordance with the CIPFA Code of Practice on Treasury Management, Appendix B.
- The Investment Strategy in accordance with the DCLG investment guidance. Appendix B

The treasury management service is an important part of the overall financial management of the Council's affairs.

- The prudential indicators consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework.

- The treasury service considers the effective funding of these decisions.

Together they form part of the process, which ensures the Council meets balanced budget requirement under the Local Government Finance Act 1992.

The Strategy should be approved by Cabinet before the start of the financial year and go to Full Council as part of the budget setting process.

Key Issues

Following the Cabinet meeting a preliminary review of the prudential indicators was carried out by the Council's treasury advisors. This has identified an amendment to the limit on borrowing activity indicator. Gross borrowing previously included short and long-term borrowing. This has been changed to include only long-term borrowing necessary to finance the capital programme.

The prudential indicators show that capital expenditure plans will need to be financed from 2008/09 onwards. Under the prudential code a three-year view can be taken to 31 March 2010 and this shows that borrowing of up to £1.7 million could be entered into to support future plans.

The treasury strategy shows that external debt is increasing with significantly reduced investment income from 2008/09 onwards. Longer term fixed rate borrowing will be required and may be undertaken in advance.

The investment strategy shows that based on cash flow forecasts cash balances will fluctuate between £1 million and £12 million in 2007/08. In future years the amount and period of investments will reduce significantly as the Council moves into debt.

Effect on strategies and codes

This report complies with CIPFA Code of Practice for Treasury Management and is part of the Council's corporate governance arrangements.

Risk Management Implications

1. Interest rate movements in respect of investment and borrowing. **The likelihood is high with medium impact.**

2. Capital expenditure and the timing of future schemes, some of which are outside the control of the council. **The likelihood is low with medium impact.**

Finance and performance implications

These are contained within the report.

Legal and human rights implications

There are no legal implications arising from this report.

Next Steps

The Council's treasury advisors will review the strategy and supporting documents.

The Head of Finance will continue to work closely with the Council's treasury advisor to determine the optimum time to enter into future borrowing arrangements under the prudential code.

Long-term borrowing is unlikely to be required until the end of 2008/09. However, this will be considered and reported to Cabinet in summer 2007 in readiness for any future need.

Recommendations

Council is recommended to agree the following:

a) Adopt the revised Prudential Indicators for 2006/07 and the Prudential Indicators and limits for 2007/08 to 2009/10 contained within Appendix A of the report.

b) Approve the Treasury Management Strategy 2007/08 and the treasury Prudential Indicators contained within Appendix B.

c) Approve the Investment Strategy 2007/08 to 2009/10 contained in the Treasury Management Strategy Appendix B.

Background Papers – files held in room F31

Appendix A

The Prudential Indicators 2007/2008 – 2009/2010

The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. This report revises the indicators for 2006/07, 2007/08 and 2008/09, and introduces new indicators for 2009/2010. Each indicator either summarises the expected activity or introduces limits upon the activity, and reflects the outcome of the Council's underlying capital appraisal systems.

Within this overall prudential framework there is a clear impact on the Council's treasury management activity, either through borrowing or investment activity. As a consequence the treasury management strategy for 2007/08 is included as Appendix B to complement the indicators, and this report includes the prudential indicators relating to the treasury activity.

Capital Expenditure Plans

The Council's capital expenditure plans are summarised below and this forms the first of the prudential indicators. This expenditure can be paid for immediately by resources such as capital receipts, capital grants, but if resources are insufficient any residual expenditure will form a borrowing need.

A certain level of capital expenditure will be grant supported by the Government. Anything above this level will be unsupported and will need to be paid for from the Council's own resources. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although no control has yet been required.

The key risks to the plans are that the level of Government support has been estimated and is therefore subject to change. Similarly some of estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale.

Below are the summary capital expenditure projections, which forms the first prudential indicator.

£m	2006/07 Revised	2007/08 Estimated	2008/09 Estimated	2009/10 Estimated
Capital Expenditure	5.045	2.582	2.338	2.372
Financed by:				
Capital receipts	3.483	0.580	-	-
Grants & Contributions	1.546	1.204	1.331	1.556
Revenue	0.016	0.044	0.024	-
Net financing need for	**-**	**0.754**	**0.983**	**0.816**

the year				

The Council's Borrowing Need - Capital Financing Requirement (CFR)

The CFR is the second prudential indicator and is simply the total outstanding capital expenditure, which has not yet been paid for from either revenue or capital resources. It is essentially a measure of Council's underlying borrowing need. The capital expenditure above which has not immediately been paid for will increase the CFR.

The Council is required to pay off an element of the accumulated General Fund capital spend each year through a revenue charge (the Minimum Revenue Provision), although it is also allowed to undertake additional voluntary payments.

Capital Financing Requirement £m	2006/07 Revised	2007/08 Estimated	2008/09 Estimated	2009/10 Estimated
Total CFR	**(0.770)**	**(0.016)**	**0.967**	**1.676**
Movement in CFR	**0**	**0.754**	**0.983**	**0.709**

Movement in CFR represented by				
Net financing need for the year (above)	0	0.754	0.983	0.816
MRP/VRP and other financing movements	0	0	0	(0.107)
Movement in CFR	**0**	**0.754**	**0.983**	**0.709**

Limits to Borrowing Activity

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

For the first of these the Council needs to ensure that its total borrowing net of any investments, does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2007/08 and next two financial years. This allows some flexibility for limited early borrowing for future years.

£m	2006/07 Revised	2007/08 Estimated	2008/09 Estimated	2009/10 Estimated
Gross Borrowing	0	0	0.967	1.676
Investments	2.600	1.000	0	0
Net Borrowing	(2.600)	(1.000)	0.967	1.676
CFR	(0.770)	(0.016)	0.967	1.676

The Head of Finance reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future.

This view takes into account current commitments, existing plans, and the proposals in this report.

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

The Authorised Limit for External Debt – This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

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

Authorised limit £m	**2006/07 Revised**	**2007/08 Estimated**	**2008/09 Estimated**	**2009/10 Estimated**
Total	4.000	5.000	4.000	6.000
Operational £m Boundary	**2006/07 Revised**	**2007/08 Estimated**	**2008/09 Estimated**	**2009/10 Estimated**
Total	2.000	3.000	2.000	4.000

Affordability Prudential Indicators

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the overall Council's finances.

Actual and Estimates of the ratio of financing costs to net revenue stream – This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

%	**2006/07 Revised**	**2007/08 Estimated**	**2008/09 Estimated**	**2009/10 Estimated**
Ratio	(3.26)	(1.68)	(1.00)	0.27

The estimates of financing costs include current commitments and the proposals in this report.

Estimates of the incremental impact of capital investment decisions on the Council Tax – This indicator identifies the revenue costs associated with ***new schemes*** introduced to the three year capital programme recommended in this report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of government support, which are not published over a three year period.

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

£	Revised Estimate 2006/07	Proposed Budget 2007/08	Forward Projection 2008/09	Forward Projection 2009/10
Council Tax - Band D	5.53	2.22	3.59	4.69

Appendix B

Treasury Management Strategy 2007/08 – 2009/10

The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators and the treasury service form part of the process, which ensures the Council meets balanced budget requirement under the Local Government Finance Act 1992. There are specific treasury prudential indicators included in this strategy which require approval.

The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). This Council adopted the Code of Practice on Treasury Management on 25 February 2004 and as a result adopted a Treasury Management Policy Statement 23 February 2005. This adoption meets the requirements of the first of the treasury prudential indicators.

The Constitution requires an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming 3 years. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced after the year-end to report on actual activity for the year.

This strategy covers:

- The Council's debt and investment projections;
- The expected movement in interest rates;
- The Council's borrowing and investment strategies;
- Treasury performance indicators;
- Specific limits on treasury activities;
- Any local treasury issues.

Debt and Investment Projections 2007/08 – 2009/10

The borrowing requirement comprises the expected movement in the CFR and any maturing debt which will need to be re-financed. The table below shows this effect on the treasury position over the next three years. It also highlights the expected change in investment balances.

£m	2006/07 Revised	2007/08 Estimated	2008/09 Estimated	2009/10 Estimated
External Debt				
Debt at 1 April	0	0	0	0.967
Movement in CFR	0	0.754	0.983	0.709

Debt at 31 March	0	0	0.967	1.676
Annual change in debt	0	0	0.967	0.709
£m	**2006/07 Revised**	**2007/08 Estimated**	**2008/09 Estimated**	**2009/10 Estimated**
Investments				
Net Investments at 31 March	2.600	1.000	0	0
Investment change	0	(1.600)	(1.000)	0

The related impact of the above movements on the revenue budget are:

£m	2006/07 Revised	2007/08 Estimated	2008/09 Estimated	2009/10 Estimated
Revenue Budgets				
Interest on Borrowing	0.039	0.054	0.054	0.072
Investment income	(0.494)	(0.304)	(0.206)	(0.136)

Expected Movement in Interest Rates

Averages %	Base Rate	5-year Gilt	20-yr Gilt	50-yr Gilt
2006/07	4.8	4.9	4.4	4.0
2007/08	5.3	5.1	4.6	4.0
2008/09	5.0	4.8	4.5	3.9
2009/10	4.8	4.5	4.3	3.9

1. Interest rate uncertainty is set to persist in the year ahead. The threat of higher inflation is considered a real danger for the UK economy in the near term, not least the possibility that an annual increase in RPI of close to 4.5% in January 2007 could translate to a buoyant pay round.
2. The Bank of England remains concerned that domestically generated inflation could strengthen in the month's ahead increase to unacceptably high levels. The key in this respect lies in a number of relationships within the economy:
   - ✓ The buoyancy of the international economy and the effect upon UK growth.
   - ✓ The strength of domestic activity and the extent of spare capacity.
   - ✓ The state of the labour market and the outcome of the forthcoming pay round.
   - ✓ The strength of domestic demand and the pricing power of companies.
3. UK growth has been stronger than expected. This has been driven mainly by domestic factors, in particular the buoyancy of consumer spending. While the recent rise in official interest rates may lead to some deceleration, the extent of this is expected to be comparatively modest.
4. Long-term interest rates have been underpinned by the twin effects of concerns about domestic inflation prospects and the unexpected

buoyancy of the US and German economies. Uncertainties generated by these developments are likely to underpin yields in the months ahead, although market conditions will remain erratic and occasional phases of downbeat economic data should generate declines in interest rates.

5. However, these phases will prove temporary until the markets are convinced the US economy has unquestionably entered a weaker activity phase and a return to lower dollar interest rates is a near certainty.

Borrowing Strategy 2007/08 – 2009/10

The uncertainty over future interest rates increases the risks associated with treasury activity. Long-term fixed interest rates are expected to rise modestly and base rates are expected to peak at 5.25%. As a result the Council will take a cautious approach to its treasury strategy.

The Head of Finance, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above. It is likely that longer term fixed rates will be considered if borrowing levels remain relatively low. This may include borrowing in advance of future years requirements.

Temporary borrowing may be undertaken from time to time when the balances held in the savings account have been exhausted. Longer-term borrowing is unlikely to be required during 2007/08 and will be considered and reported to Cabinet in readiness for any future need.

Investment Counterparty and Liquidity Framework

The primary principle governing the Council'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 Council will ensure:

- 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 Council's prudential indicators covering the maximum principal sums invested.

- 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.

The Head of Finance will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. This criteria is separate to that which chooses

Specified and Non-Specified investments as it selects which counterparties the Council will choose rather than defining what its investments are.

- **Banks** – the Council will use banks which have at least the following Fitch or equivalent ratings:
  - **Short Term** F1
  - **Long Term** A- (A- is minimum and AAA+ is maximum)
  - **Individual / Financial Strength** C
  - **Support** 3
- **Building Societies** use all Societies, which meet the ratings for banks outlined above.
- **Money Market Funds** AAA
- **UK Government, Local Authorities, Parish Councils etc** will not be subject to specified criteria

The time limits for institutions on the Council's Counterparty List are as follows these will cover both Specified (high security/liquidity less than one year low risk) and Non-Specified Investments (greater than one year including forward deals with bank or building society with minimum long term credit rating of A-):

	Fitch	Moody's	Standard & Poors	Money Limit	Time Limit
Banks/Building Soc	*F1*	P-1	A-1	£15m	3yrs
Other Institution Limits - LA and MM	-	-	-	£3m	3yrs

The use of longer term instruments within the Non-specified investment category. These instruments will only be used where the Council's liquidity requirements are safeguarded. This will also be limited by the investment prudential indicator below.

Investment Strategy 2007/08 – 2009/10

This sets out the general policy objective for investments. The Council will have regard to the ODPM's (now DCLG) Guidance on Local Government Investments ("the Guidance") issued in March 2004 and CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code").

The Treasury Management Schedules and Practices contained within the CIPFA guidance are being updated for recent changes and anticipated move away from debt free status. Theses will be presented to Council for approval in early summer.

All investments will be in sterling. The general policy objective for this Council is the prudent investment of its treasury balances, including monies borrowed for the purpose of expenditure in the reasonably near future (i.e. borrowed 12-18 months in advance of need).

Based on its cash flow forecasts, the Council anticipates its fund balances in financial year 2007/08 to range between £1m and £12million. This variability is largely due to the temporary in and outflows of cash expected over the year such as capital expenditure or Council Tax and Business Rates.

During the 2007/08 £1.7 million has been earmarked for capital spending commitments an additional £1.3 million 2008/09 and a further £1 million in 2009/10. It is anticipated that we may see slippage to the timing of this spend.

Giving due consideration to the Council's level of balances over the next 3 years, the need for liquidity, its spending commitments and provisioning for contingencies, the Council has determined that £1million of its overall fund balances can be prudently committed to longer term investments (i.e. those with a maturity exceeding a year

For cashflow generated balances, the Council will seek to utilise business reserve accounts and short dated deposits in order to maximise investment interest. The following investments are currently held:

i) Short-term surplus cash is invested with Abbey National Business Reserve Account, which follows the base rate. Currently 5.38% for balances over £3 million.
ii) Other short-term deposits are made when cash surpluses are above the maximum limits of the Business Reserve Accounts.

Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of peaking at 5.25% in early 2007. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts. It is likely that investment decisions will be made for longer periods with fixed investments rates to lock in good value and security of return if opportunities arise.

The Head of Finance, under delegated powers, will undertake the most appropriate form of investments depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above.

Treasury Management Prudential Indicators and Limits on Activity

There are four further treasury prudential indicators. The purpose of these prudential indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs. The indicators are:

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

- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.
- Total principal funds invested for greater than 364 days – These limits are set to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

£m	2007/08	2008/09	2009/10
Interest rate Exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	3.000	0	(2.000)
Limits on variable interest rates based on net debt	12.000	9.000	7.000
Limits on fixed interest rates: **. Debt only** **. Investments only**	 0.0 3.000	 2.000 2.000	 3.000 1.000
Limits on variable interest rates: **. Debt only** **. Investments only**	 3.000 15.000	 3.000 12.000	 3.000 10.000
Maturity Structure of fixed interest rate borrowing 2007/08			
		Lower	**Upper**
Under 12 months		0%	100%
12 months to 2 years		0%	100%
2 years to 5 years		0%	100%
5 years to 10 years		0%	100%
10 years and above		0%	100%
Maximum principal sums invested > 364 days			
Principal sums invested > 364 days	£1m	£0m	£0m

Performance Indicators

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

- Debt – Borrowing - Average rate of borrowing for the year compared to average available
- Debt – Average rate movement year on year
- Investments - total interest generated
- Investments – Internal returns above the 7 day LIBID rate

The results of these indicators will be reported in the Treasury Annual Report for 2006/07.