Meeting:	Cabinet
Date:	16 February 2006
Subject:	Treasury Management Strategy 2006-07 and Prudential Indicators 2006-07 to 2008-09
Responsible Officer:	Myfanwy Barrett – Director of Financial and Business Strategy
Contact Officer:	Barry Evans – Group Manager (Corporate Finance)
Portfolio Holder	Business Connections and Performance
Key Decision:	No
Status:	Part 1

Section 1: Summary

Decision Required

The Cabinet is requested to:

i) recommend to Council the approval of the Treasury Management Strategy for 2006-07 set out in paragraphs 1 to 16;

ii) approve the Council's lending list as set out in appendix 2;

iii) recommend to Council the approval of the Prudential Indicators for 2007-08 to 2008-09 set out in paragraphs 17 to 38.

Reason for report

To promote effective financial management and comply with the Local Authorities

(Capital Finance and Accounting) (England) Regulations 2003 and other relevant guidance.

Benefits

The Council's lending and borrowing policies and performance underpin the revenue budget and the achievement of the capital programme and therefore indirectly contribute to all the Council's corporate priorities.
The Prudential Indicators provide the framework for investment and borrowing decisions.

Cost of Proposals

Not applicable

Risks

None associated directly with approving the Treasury Management Strategy and Prudential Indicators.

Implications if recommendations rejected

Failure to approve the Treasury Management Strategy and Prudential indicators would mean that the Council had not complied with legislation and guidance. In addition it could have an adverse impact on decision making in relation to investments and borrowing and lead to criticism from external audit.

Section 2: Report

Summary

1. The Council is required to approve a Treasury Management Strategy each year. The proposed strategy for 2006-07 is based on the following principles:
    - The Council will comply with ODPM guidance on local government investments.
    - The Council will comply with the CIPFA Code of Practice for Treasury Management.
    - The Council delegates responsibility for the implementation and monitoring of its treasury management policy to Cabinet and for the execution and administration of treasury management decisions to the Council's Section 151 Officer.
    - Priority when making investments will be given to security and liquidity rather than yield – however yield will not be ignored; it is reasonable to seek the highest rate of interest, though this needs to be consistent with proper levels of security and liquidity.
    - The Council's investments will be made largely by way of fixed rate deposits with leading financial institutions and local authorities. There will be a wide spread of placements in order to minimize exposure to risk.
    - The Council will continue to use money market funds.
    - The Council will employ a fund manager to manage a portfolio of £30m.

- In compiling forecasts for investment income a prudent view will be taken of interest rates.
- Borrowing will be managed with a view to achieving a competitive interest rate and appropriate maturity profile.
- New borrowing will be taken out to finance capital expenditure in line with the approved capital programme and prudential indicators.
- All transactions carried out via the London Wholesale Money Market will be governed by the Bank of England's Non-Investment Product Code.

2. In addition the Council is required to approve a number of prudential indicators for 2006-07 to 2008-09. The key objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable. A further key objective is to ensure that treasury management decisions are taken in accordance with good professional practice and in a manner that supports prudence, affordability and sustainability. To demonstrate that local authorities have fulfilled these objectives the code sets out the indicators that must be used and the factors that must be taken into account.

3. The prudential indicators relate to:
   - Level of capital expenditure
   - Ratio of capital financing costs to net revenue stream
   - Incremental impact of capital investment on Council Tax and rents
   - Authorised limit and operational boundaries for borrowing
   - Net borrowing and the capital financing requirement
   - Compliance with CIPFA's treasury management code of practice
   - Interest rate exposure
   - Maturity structure of borrowing
   - Total principal sums invested for more than 364 days

4. Reports on Treasury Management issues and Prudential Indicators will be considered by the Budget Review Working Group throughout the year.

<u>Treasury Management Strategy</u>

5. The Council will comply with the ODPM guidance on local government investments outlined in Appendix 1. The proposed lending list is attached at Appendix 2 for approval.

6. The Council will comply with CIPFA's Treasury Management Code of Practice.

7. Cabinet is reminded that the council delegates responsibility for the implementation and monitoring of its treasury management policies and practices to Cabinet and for the execution and administration of treasury management decisions to the Council's Section 151 Officer (Chief Finance Officer, currently the Director of Financial and Business Strategy), who will act in accordance with the Council's policy statement and Treasury Management Practices and if, he/she is a CIPFA member, CIPFA's Standard of Professional Practice on Treasury Management.

Investment

8. The Council's lending policies emphasise security of funds in a volatile and uncertain market largely by way of fixed rate deposits with leading financial institutions and local

authorities. The level of deposits with any one institution is capped to ensure a wide spread of placements in order to minimise exposure to risk. A full list of borrowers together with lending limits and the 'Fitch' credit ratings is attached at Appendix 2. Fitch Ratings Ltd. is one of the leading international credit rating agencies. Where possible deposits are also spread through the coming year to ensure that advantage can be taken of any unexpected increase in interest rates, whilst avoiding a large exposure to equally sudden falls. Appendix 3 shows the current profile of lending, including investments of more than 364 days.

9. When deciding the duration of day to day deposits both cash flow requirements and future interest rate movements have to be taken into consideration. The UK base rate is currently 4.50%, however the economic situation in the UK and globally can change rapidly. This means that strategy must be flexible, in order to take advantage of any unexpected movements in the market. Basing strategy on market forecasts at one point in the year can leave the Council open to reduced returns as circumstances change.

Money Market Funds and Deposit Account

10. As from 1 April 2002 local authorities were able to invest in Money Market Funds. These are mutual funds that have the advantage of offering a standard rate of interest regardless of the size of deposit. The Council has accounts with five Money Market Funds and also operates a deposit account with the Bank of Scotland on which interest is paid at base rate. These accounts are used as part of the strategy to optimize returns on monies held for short periods of time and it is proposed that their use is continued.

External Cash Managers

11. Scottish Widows Investment Partnership (SWIP) was appointed in 2005 to manage a cash fund of £30m, the contract commenced on 1 December 2004.

12. SWIP have been set a target of outperforming the 7 day LIBID rate (compounded weekly) by 115% over a rolling 3 year period. Up to 100% of the fund can be invested in UK Government Securities and the maximum permitted weighted average duration of the portfolio is 5 years. This approach to the external funds gives the manager the opportunity to maximize returns by taking full advantage of longer term investments, if they believe this to be the correct course of action. The higher risk of this strategy is counterbalanced by all the monies managed internally being held in shorter term cash investments.

Estimated income from investments

13. The revenue budget for 2006-07 assumes that interest rates over the year will average between 4.25% and 4.5%%, giving a total interest received figure of £4.69m. Predictions from economists for interest rates at the end of 2006 currently vary from 3.75% up to 4.75%. Investments are made with the aim of safeguarding the Council's budget position and the security of the investment, whilst always attempting to optimise the return on investments.

Debt Management and Borrowing

14. The Council's borrowing requirement for 2006-07 is derived from the capital programme. It is not possible to say at this time exactly how this requirement will be met as flexibility needs to be maintained to use the most appropriate form of funding available. In December 2005 the Public Works Loans Board (PWLB) increased the maximum period for fixed rate loans from 30 years to 50 years. This enabled the Council to restructure some outstanding debts to 49 and 50 years producing savings to the General Fund of approximately £290,000. At the present time 25 year fixed rate loans can be obtained from the PWLB at 4.15%, which is less than the cost in terms of investment income foregone associated with using reserved receipts.

15. As part of the restructuring exercise the opportunity was taken not only to make savings but also to introduce £20.8m of variable rate loans into the portfolio. Although the bulk of investments are at short-term (less than 364 days) rates, advantage has been taken of the freedoms introduced by the Prudential Code to invest up to £20m for periods of up to 4 years. These gradual changes will mean that the revenue budget is less exposed to fluctuations in short-term interest rates. In the longer term the aim is to achieve a balance of fixed and variable rates. Sterling Consultancy Services were engaged to carry out the recent review of the debt portfolio and will continue to provide debt management advice throughout 2005.

16. A graph at Appendix 4 shows the current structure and maturity profile of the Council's Long Term Debt Portfolio.

Prudential Indicators

17. The Prudential Code for Capital Finance came into effect from 1 April 2004. The key objectives of the Prudential Code are to ensure that the capital investment plans of local authorities are affordable, prudent, sustainable, and follow good practice.

18. To demonstrate that each authority fulfils these objectives the Code sets out a number of indicators and factors that must be considered. Set out below are the indicators that must be approved at the same time as the Council's revenue and capital budgets are set.

Capital Expenditure

19. The actual capital expenditure that was incurred in 2004-05 and the estimates of gross capital expenditure to be incurred for the current and future years that are recommended for approval are shown in Table 1. These are shown in summary only, the detailed capital programme is reported elsewhere on the Cabinet's agenda.

	2004-05 £000 Actual	2005-06 £000 Estimate	2006-07 £000 Estimate	2007-08 £000 Estimate	2008-09 £000 Estimate
Non-HRA	33,237	55,260	58,383	42,849	29,624
HRA	6,861	9,963	7,674	7,838	8,013
Total Programme	40,098	65,223	66,057	50,687	37,637

Ratio of Financing Costs to Net Revenue Stream

20. The financing costs of the council include interest payable in respect to borrowing, finance leases and other long-term liabilities and the minimum revenue provision. Netted off against these expenses is interest earned on investments. The Prudential Code states that figures should be taken directly from a council's accounts and balance sheets.

21. Estimates of the ratio of financing costs to net revenue stream for the current and future years, and the actual figures for 2004-05 are:

	2004-05 £000 Actual	2005-06 £000 Estimate	2006-07 £000 Estimate	2007-08 £000 Estimate	2008-09 £000 Estimate
Non-HRA	2.9%	4.0%	4.8%	5.7%	5.8%
HRA	30.1%	32.1%	34.3%	41.3%	39.9%

Impact on Council Tax and Rents

22. The Band D Council Tax that would result for 2006-07 from the totality of the capital and revenue plans recommended in the Budget report is £1,072. With respect to the HRA the average weekly rent that would result for 2006-07 is £77.42.

23. Forward estimates for the Band D Council Tax for 2007-08 and 2008-09 are £1,134 and £1,208 respectively, and for the HRA the average weekly rent would be £81.02 and £84.85. These forward estimates are not fixed and do not commit the council. They are based on the Council's existing commitments, current plans and the totality of the capital and revenue plans recommended in the budget report. There are no known significant variations beyond this timeframe that would result from past events and decisions or the proposals in this budget.

24. The estimate of the incremental impact of the capital investment decisions proposed elsewhere on the Cabinet's agenda, over and above capital investment decisions that have previously been taken by the council are:

	2006-07	2007-08	2008-09
Band D Council Tax	£14.57	£31.11	£33.57
Average weekly housing rents	nil	nil	nil

Borrowing

25. In respect of its external debt, it is proposed that Cabinet recommends to Council that it approve the following Authorised Limits for its total external debt gross of investments for the next three financial years. These limits separately identify borrowing from other long-term liabilities such as finance leases. When approving these limits it is also recommended that authority be delegated to the Council's Chief Finance (Section 151) Officer to effect movement between the separately agreed limits for borrowing and other long term liabilities, in accordance with option appraisal and best value for money for the authority, always providing that the total limit for the year is not exceeded.

26. Cabinet are asked to recommend to Council the following Authorised Limits and Operational Boundaries for external Debt. The limits are consistent with the Council's planned capital expenditure and financing.

Authorised Limit for External Debt

	2005-06	2006-07	2007-08	2008-09
	£m	£m	£m	£m
Borrowing	231	280	317	344
Other long term liabilities	3	3	3	3
Total	**234**	**283**	**320**	**347**

Operational Boundary for External Debt

	2005-06	2006-07	2007-08	2008-09
	£m	£m	£m	£m
Borrowing	204	253	293	317
Other long term liabilities	3	3	3	3
Total	**207**	**256**	**296**	**320**

27. The Authorised Limit determined for 2005-06 is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Net Borrowing and Capital Financing Requirement

28. Estimates of the end of year Capital Financing Requirement for the authority for the current and future years and the actual Capital Financing Requirement at 31 March 2005 are:

As at 31 March	2005	2006	2007	2008	2009
	£000	£000	£000	£000	£000
	Actual	Estimate	Estimate	Estimate	Estimate
Non-HRA	86,437	107,978	144,510	171,235	184,910
HRA	24,098	26,698	29,605	31,829	33,096

29. In day-to-day cash management no distinction can be made between revenue cash and capital cash, meaning that external borrowing can arise as a result of the combined financial transactions of the authority and not simply those that arise from capital expenditure. In contrast, the Capital Financing Requirement measures the council's underlying need to borrow purely for capital purposes. In accordance with best practice, the council does not associate borrowing with particular items or types of expenditure. The Cabinet approves a treasury management strategy on an annual basis and has adopted the 'CIPFA Code of Practice for Treasury Management in the Public Services'.

30. The Prudential Code states that, in order to ensure that over the medium term 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 the Capital Financing Requirement in the previous year plus the estimates of any additional Capital Financing Requirement for the current and next two financial years.

31. For Harrow this gives a figure of approximately £203m at present, where as net debt at 31 March 2006 will be in the region of £90m. Therefore there is scope to increase the borrowing limits in future years if required.

Interest Rate Exposures

32. Fixed rate borrowing and investment can contribute significantly to reducing the uncertainty surrounding future interest rate movements, however the pursuit of optimum performance may justify retaining a degree of flexibility through the use of variable rates for some element of borrowing. The Code identifies two indicators that will provide the Operational Boundaries for the exposure to interest rate risks.

- Upper limits for variable rate exposure
- Upper limits to fixed interest rate exposure

33. The Code requires that limits are set as a percentage of either net principal outstanding or net interest payable. At present all but £20.8m of the Council's borrowing is at fixed rates while the bulk of investments are deemed to be variable, being held in deposits of less than 365 days. This situation makes the calculation of any meaningful indicator almost impossible, however, the debt structure will be kept under review with the intention of working towards a more balanced position in the longer term, and interest rate exposure will be a factor in any borrowing decisions taken in the year.

Maturity Structure of Borrowing

34. The code states that a local authority should set for the forthcoming financial year limits with respect to the maturity structure of its borrowing. These prudential indicators will be for both upper and lower limits and are calculated as the amount of projected borrowing at fixed rates that are due to mature in each period expressed as a percentage of the total projected borrowing that is at fixed rates. The periods are set as follows:

    Under 12 months
    12 months, and under 24 months
    24 months, and within 5 years
    5 years, and within 10 years
    10 years and above

35. The maturity of the debt is determined by reference to the earliest date on which the lender can require payment. After considering the current maturity profile of the Council's debt (as shown in appendix 4) the following limits are put forward for approval.

	Upper Limit	Lower Limit
Under 12 months	20%	0%
12 months, and under 24 months	20%	0%
24 months, and within 5 years	30%	0%
5 years, and within 10 years	40%	10%
10 years and above	85%	10%

36. The recent debt restructuring exercise has increased the average duration of debt. As the new debt has been secured at a very low rate from the PWLB (based on a review of PWLB rates in the past) this is not deemed to represent a significant risk.

Investing for periods longer than 364 days

37. The code states that where a local authority invests, or plans to invest, for periods longer than 364 days an upper limit will be set for each forward financial year. The purpose of this indicator is for a local authority to contain its exposure to the possibility of loss that may arise as a result of its having to seek early repayment or redemption of principal sums invested. This is one of the freedoms offered to local authorities by the new regime. In a volatile market and partly to offset the problems that can be caused by the high ratio of fixed rate debt to variable rate investments it proposed that the following limits are again set for sums invested for maturity in future years as follows:

To mature within:			% of portfolio
Year 1	365 days to 1 year 364 days	£10m	10% (approx)
Year 2	2 years to 2 years 364 days	£5m	5% (approx)
Year 3	3 years to 3 years 364 days	£5m	5% (approx)

38. The actual amounts invested for these longer periods will be determined as part of the ongoing management of the investment of the council's general balances, and will depend on the rates on offer at the time, and any funds that may be held in future and earmarked for a particular purpose, such as PFI receipts. At present long and short term rates are very close together. It should be noted that these limits apply only to the investments managed internally, the external cash managers use longer dated instruments that are limited by the management agreement.

Consultation

39. None

Financial Implications

40. This is a report of the Director of Financial and Business Strategy and deals with financial matters throughout.

Legal Implications

41. Compliance with the ODPM Guidance and the CIPFA Code of Practice will help ensure compliance with the relevant law.

Equalities Impact

42. No direct impact.

Section 17 Crime and Disorder Act 1998 Considerations

43. N/A

Section 3: Supporting Information/Background Documents

There are a number of appendices to the Treasury Management Strategy

Appendix 1 – Specified and Non-Specified Investments
Appendix 2 – Borrowers and lending limits
Appendix 3 – Current structure of lending

Appendix 4 – Current structure of long term borrowing

The Prudential Code for Capital Finance in Local Authorities (CIPFA)
Treasury Management in the Public Services : Code of Practice and Cross Sectoral Guidance Notes (CIPFA)
Local Government Investments – Guidance (Office of the Deputy Prime Minister)

Any person wishing to inspect the background papers should telephone 020 8424 1170

Local Government Investments

Revised guidance from the Office of the Deputy Prime Minister (ODPM) relating to Local Government Investments came into effect on 1 April 2004. The main points of the Guidance are outlined below.

- The Approved Investments Regulations ceased on 1 April 2004
- Priority when making investments should be given to security and liquidity, rather than yield. Yield should not be ignored; it is reasonable to seek the highest rate of interest, though this needs to be consistent with proper levels of security and liquidity.
- The speculative procedure of borrowing purely in order to invest and make a return remains unlawful
- There are two types of investment – specified and non-specified

Specified

These investments must be in sterling, with a maturity of no more than 1 year and with either:

1. The UK government or a UK local authority
   OR
2. Bodies or investment schemes with a 'high' credit rating

No definition is given in the Guidance as to what is considered 'high' for each type of investment. The Council's Annual Treasury Management Strategy is to determine what is 'high' and will say how frequently ratings will be monitored

Non-specified

The Annual Treasury Management Strategy must deal in more detail with non-specified investments, because of the greater potential risk. It must identify the general types of investments that may be used and set a limit to the overall amount that may be held. This can be a fixed amount or a percentage. The Strategy should also give guidelines on making decisions about such investments e.g. taking of professional advice.

- The Strategy must lay down principles for determining the amount of funds that can prudently be committed for more than a year and the minimum amount that is to be held in short-term investments.
- The Annual Treasury Management Strategy (and any variations) is to be approved by the full Council and made available to the public.
- This guidance does not apply to council Pension Funds.

With regard to credit ratings for Specified investments appendix 2 shows the credit rating for each of the institutions on the Council's lending list. Non UK banks were introduced to the list on the basis of the following minimum FITCH IBCA ratings, shown with their definitions.

Long Term AA-

Very high credit quality – AA ratings denote a very low expectation of credit risk, a very strong capacity for timely payment of financial commitments and are not significantly vulnerable to foreseeable events.

Short Term F1+
Highest credit quality – F1 indicates the strongest capacity for timely payment of financial commitments, the ‘+’ denotes an exceptionally strong credit feature.

Support 2
A bank for which there is a high probability of external support. The potential provider of support is highly rated in its own right and has a high propensity to provide support to the bank in question.

Individual B
Category ‘A’ denotes a very strong bank, category ‘B’ is a strong bank, where there are no major concerns. Characteristics may include strong profitability and balance sheet integrity, franchise, and management, operating environment or prospects.

Ratings will be checked on a monthly basis, on receipt of the ratings guide from FITCH Ratings Ltd.

Investments with Building Societies are non-specified. With the exception of the Nationwide, none of the building societies have credit ratings that could be termed ‘high’. The bulk of the Council’s investments are held with building societies. Each has a wide asset base and it is nearly 60 years since any money was lost through investing with a building society. Lending limits are set dependent upon the asset size of the building society. The limit that was applied on investments with non specified Building Societies for 2004-05 was 90% of the Council’s internally managed Investments (at the time of the deal). This works well and it is proposed that this should continue. To reduce risk further, a limit is also set on the amount placed with any one building society at any time and investment with smaller societies has a maximum duration of 364 days.