Meeting:	Cabinet
Date:	15 February 2007
Subject:	Treasury Management Strategy 2007-08 and Prudential Indicators 2007-08 to 2009-10
Key Decision:	No
Responsible Officer:	Myfanwy Barrett – Director of Financial and Business Strategy
Portfolio Holder	David Ashton (Portfolio Holder for Finance and Business matters)
Status:	Part 1
Enclosures:	Appendix 1 – Specified & Non-Specified Investments Appendix 2 – Borrowers and lending limits Appendix 3 – Current structure of lending Appendix 4 – Current structure of long term borrowing

SECTION 1: SUMMARY AND RECOMMENDATIONS

This report sets out the Council's Treasury management Strategy for 2007-08 and the levels at which the Prudential indicators should be set for the 3 financial years 2007-08 to 2009-10.

RECOMMENDATIONS:

The Cabinet is requested to:

i) recommend to Council the approval of the Treasury Management Strategy for 2007-08 set out in paragraphs 5 to 17;

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 2009-10 set out in paragraphs 18 to 39.

REASON:
To promote effective financial management and comply with the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 and other relevant guidance.

SECTION 2: REPORT

Summary

1. The Council is required to approve a Treasury Management Strategy each year. The proposed strategy for 2007-08 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 (plus accumulated income).
   - 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 2007-08 to 2009-10. 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.

Treasury Management Strategy

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 5.25%, 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 2004 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.

13. The performance to date of SWIP has been disappointing, however the company were engaged on the basis that this was a longer-term investment. Officers meet with the cash managers on a regular basis and performance will be reviewed against the target at the end of November 2007, when the fund has been running for 3 years.

Estimated income from investments

14. The revenue budget for 2007-08 assumes that interest rates over the year will remain stable at 5.0% on average, giving a total interest received figure of £4.59m. Predictions from economists for interest rates at the end of 2007 currently vary from 4.50% up to 5.50%. 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

15. 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. At the present time 25 year fixed rate loans can be obtained from the PWLB at 4.70%, which is less than the cost in terms of investment income foregone associated with using reserved receipts.

16. The restructuring exercise carried out in 2005-06 introduced £20.8m of variable rate loans into the portfolio, which reduces interest rate risk exposure. 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 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.

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

Prudential Indicators

18. 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.

19. 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

20. The actual capital expenditure that was incurred in 2005-06 and the estimates of gross capital expenditure to be incurred for the current and future years that are recommended for approval are shown below. These are shown in summary only, the detailed capital programme is reported elsewhere on the Cabinet's agenda.

	2005-06 £000 Actual	2006-07 £000 Estimate	2007-08 £000 Estimate	2008-09 £000 Estimate	2009-10 £000 Estimate
Non-HRA (gross)	53,710	72,907	49,268	52,931	43,742
Non HRA (net)	**43,970**	**52,336**	**29,143**	**28,219**	**25,845**
HRA (gross)	8,210	8,269	12,300	12,500	10,500
HRA (net)	**4,619**	**4,767**	**8,703**	**8,838**	**6,772**
Total Gross	61,920	81,176	61,568	65,431	54,242
Total (net)	**48,589**	**57,103**	**37,846**	**37,057**	**32,617**

Ratio of Financing Costs to Net Revenue Stream

21. The financing costs of the council include interest payable in respect of 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.

22. Estimates of the ratio of financing costs to net revenue stream for the current and future years, and the actual figures for 2005-06 are:

	2005-06 £000 Actual	2006-07 £000 Estimate	2007-08 £000 Estimate	2008-09 £000 Estimate	2009-10 £000 Estimate
Non-HRA	4.2%	5.1%	5.7%	5.4%	5.1%
HRA	30.7%	32.7%	31.8%	33.01%	34.5%

For the general fund the net revenue stream is equal to the 'amount to be met from Government Grant and Local Tax Payers' i.e. total net expenditure. The movements in the general fund ratio reflect the delayed impact of the increase in the size of the capital programme in recent year and then the decrease over the next three years.

Impact on Council Tax and Rents

23. The Band D Council Tax that would result for 2007-08 from the totality of the capital and revenue plans recommended in the Budget report is £1,119.50 (draft). With respect to the HRA the average weekly rent that would result for 2007-08 is £81.19.

24. Forward estimates for the Band D Council Tax for 2008-09 and 2009-10 are £1,153.14 and £1,153.16 respectively, and for the HRA the average weekly rent would be £85.25 and £89.51. 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.

25. The estimate of the incremental impact of the revenue growth resulting from the capital investment decisions proposed elsewhere on the Cabinet's agenda are shown below. The increase in housing rents will be used to contribute towards the cost of the capital programme and will enable the council to meet the government's decent homes standard.

	2007-08	2008-09	2009-10
Band D Council Tax	£34.80	£21.50	£19.87
Average weekly housing rents	£3.77	£4.06	£4.26

Borrowing

26. 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 authority is also 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.

27. 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

	2006-07	2007-08	2008-09	2009-10
	£m	£m	£m	£m
Borrowing	293	323	349	370
Other long term liabilities	-	-	-	-
Total	**293**	**323**	**349**	**370**

Operational Boundary for External Debt

	2006-07	2007-08	2008-09	2009-10
	£m	£m	£m	£m
Borrowing	256	286	312	333
Other long term liabilities	-	-	-	-
Total	**256**	**286**	**312**	**333**

28. The Authorised Limit determined for 2007-08 is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Net Borrowing and Capital Financing Requirement

29. 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 2006 are:

As at 31 March	2006 £000 Actual	2007 £000 Estimate	2008 £000 Estimate	2009 £000 Estimate	2010 £000 Estimate
Non-HRA	122,491	157,684	174,613	186,440	194,921
HRA	28,060	31,201	38,404	45,742	51,014

30. 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'.

31. 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.

32. For Harrow this gives a figure of approximately £236m at present, where as net debt at 31 March 2007 will be in the region of £163m. Therefore there is scope to increase the borrowing limits in future years if required.

Interest Rate Exposures

33. 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

34. 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

35. 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

36. 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, which are the same as for the current year, 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%

37. The debt restructuring exercise carried out in 2005-06 increased the average duration of debt. To counter balance this position it is intended to take future loans for periods of 30 years or less, while aiming to keep within an average interest rate for new debt of 4.50%.

Investing for periods longer than 364 days

38. 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)

39. 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 rates for periods of 1 to 4 years are around 0.50% higher than base rate. 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.

40. As part of the partnership with Capita, Sector Treasury Services have been engaged to carry out a review of the Council's balance sheet. The review will include consideration of working capital, the level of balances, reserves and capital receipts. The Sector report should be received in March and will be used to inform the strategy for capital investment over the next 10 years.

Consultation

41. None

Financial Implications

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

Legal Implications

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

Equalities Impact

44. No direct impact.

Section 3: Statutory Officer Clearance

Chief Finance Officer	✔	Name: Myfanwy Barrett Date: 25 January 2007
Monitoring Officer	✔	Name: Jill Travers Date: 2 February 2007

Section 4: Contact details and background papers

Contact: Barry Evans (Group Manager - Corporate Finance) tel: 020-8424-1203

Background Papers:

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)

1.	Consultation	N/A
2.	Corporate Priorities	Yes (D)
3.	Community Safety (s17 Crime and Disorder Act 1998)	N/A
4.	Manifesto Pledge Reference Number	Yes (D)

Appendix 1

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 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 is 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.