TITLE:	**Treasury Management Strategy Report 2006/07**
TO/ON:	**Executive 8th March 2006**
BY:	**Director of Finance**
STATUS:	**Report**
PORTFOLIO:	**Learning**

1. SUBJECT MATTER AND PURPOSE OF REPORT

1.1. This report summarises the Council's prudential indicators for 2006/07 to 2008/09 which have been reported to Council as part of the 2006-09 Medium Term Financial Plan and sets out the expected treasury operations for this period. It contains three key Council reporting requirements:

- A summary of the prudential indicators as approved at Special Council on 21st February 2006;
- The treasury strategy in accordance with the CIPFA Code of Practice on Treasury Management
- The investment strategy (in accordance with the ODPM investment guidance) at Appendix A.

2. BACKGROUND

2.1. The capital expenditure and treasury procedures are now firmly established. The Council has freedom over capital expenditure so long as it is prudent, affordable and sustainable. In order to show it is working within these limits the Council must approve, revise and monitor at least a basic range of prudential indicators covering the forthcoming three years. The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators.

2.2. 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 2006/07 is included to complement the indicators. This report also includes a summary of the prudential indicators relating to the treasury activity. The production of the treasury management strategy is a requirement of the CIPFA Code of Practice on Treasury Management. Compliance with this Code is required by the Prudential Code

2.3. This report has been prepared in the context of the recent vote in favour of the LSVT of housing to Derwentside Homes. The proposed transfer will have a significant impact in terms of the Authority's Capital

Expenditure, Debt Charges and Treasury position, particularly the level of outstanding debt held by the Authority. At this stage it has been necessary to make various assumptions regarding the timing and impact of the transfer, which have had a major bearing on some of the Prudential Indicators from 2006/07 onward. The full implications for the Authority's Treasury position will become clearer as the transfer progresses, and any material changes will be presented to Members in future reports

3. MATERIAL CONSIDERATIONS/AVAILABLE OPTIONS

3.1. **Summarised Prudential Indicators –** The prudential indicators that have already been approved by Special Council on 21st February are summarised below for completeness. It should be noted that the first prudential indicator is the adoption of the CIPFA Code of Practice on Treasury Management which the Council complies with via its own Treasury Management Strategy.

Table 1

Capital Expenditure and Affordability Prudential Indicators

Prudential Indicators	2005/06 Revised £000s	2006/07 Estimated £000s	2007/08 Estimated £000s	2008/09 Estimated £000s
1.Capital Expenditure	16,724	22,979	9,945	9,492
2.Capital financing requirement	43,213	12,919	12,402	11,906
3.Authorised limit for external debt	61,669	76,350	18,651	18,651
4.Operational boundary for external debt	51,474	63,875	14,693	14,693
5.Ratio of financing costs to net revenue stream – Non HRA	0.11%	0.04%	(1.90%)	(2.20%)
6.Ratio of financing costs to net revenue stream –HRA	15.8%	14.70%	0	0
7.Incremental impact of capital investment decisions on the Band D Council Tax	0	0	0	0
8.Incremental impact of capital investment decisions on housing rents levels	0	0	0	0

Table 2

Treasury Management Prudential Indicators and Limits on Activity

	2006/07 Upper		2007/08 Upper		2008/09 Upper	
Limits on fixed interest rates based on net debt	220%		0%		0%	
Limits on variable interest rates based on net debt	25%		-50%		-50%	
Maturity Structure of fixed interest rate borrowing						
	Lower	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	0%	100%	0%	70%	0%	30%
12 months to 2 years	0%	100%	0%	70%	0%	40%
2 years to 5 years	0%	100%	0%	80%	0%	60%
5 years to 10 years	0%	100%	0%	80%	0%	80%
10 years and above	0%	100%	0%	100%	0%	100%
Maximum principal sums invested > 364 days	£m 15		£m 15		£m 15	

The summary capital expenditure projections on which some of these indicators are based is shown in the table below:

Table 3

Capital Expenditure and Financing

	2004/05 Actual £000s	2005/06 Revised £000s	2006/07 Estimated £000s	2007/08 Estimated £000s	2008/09 Estimated £000s
Capital Expenditure					
Total expenditure	13,085	16,724	22,979	9,945	9,492
Financed by:					
Capital receipts	2,943	10,447	11,988	9,260	9,260
Capital grants	3,635	1,512	6,984	685	232
Capital reserves	5,475	3,707	3,923	0	0
Revenue	0	0	0	0	0
Net financing need for the year	**1,032**	**1,058**	**84**	**0**	**0**

3.2. Treasury Management Strategy 2006/07 – 2008/09

3.2.1. The treasury management service is an important part of the overall financial management of the Council's affairs. Whilst the prudential indicators above consider the affordability and impact of capital expenditure decisions, the treasury service covers the effective funding of these decisions.

3.2.2. 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 03/11/03, and as a result adopted a treasury management policy. This adoption meets the requirements of the first of the treasury prudential indicators.

3.2.3. The policy requires an annual strategy to be reported to Cabinet/committee outlining the expected treasury activity for the forthcoming 3 years. A further report is produced after the year-end to report on actual activity for the year.

3.2.4. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service.

3.2.5. This strategy covers:

- The current treasury position
- The expected movement in interest rates
- The Council's borrowing and debt strategy
- The Council's investment strategy (in compliance with the ODPM guidance)
- Treasury performance indicators
- Specific limits on treasury activities
- Local treasury issues

3.3. Treasury Position

Table 4

Treasury Position

	2004/05 Actual £000s	2005/06 Revised £000s	2006/07 Estimated £000s	2007/08 Estimated £000s	2008/09 Estimated £000s
External Debt					
Borrowing	42,810	42,810	10,910	10,910	10,910
Other long term liabilities	0	0	0	0	0
Debt at 31 March	42,810	42,810	10,910	10,910	10,910
Annual change in debt	(1,900)	0	(31,900)	0	0
Investments					
Total Investments at 31 March	11,130	13,454	12,576	10,174	6,538
Investment change	3,320	2,324	(878)	(2,402)	(3,636)
Revenue Budgets					
Interest on Borrowing	2,522	2,523	2,549	466	476
Investment income	520	805	915	1,325	1,361

3.3.1. The figures shown in this table are based on the assumption that all the Authority's PWLB debt is redeemed as part of the LSVT transfer process.

3.4. Expected Movement in Interest Rates

3.4.1. The Monetary Policy Committee announced the long-awaited cut in base rates following its August meeting. However, the downturn in the UK interest rates cycle is expected to be prolonged and shallow with the low point not being too wide of the 4.25% level (currently 4.5%). GDP growth had been substantially weaker than anticipated as the slowdown in house price inflation and higher debt servicing costs combined to undermine consumer spending growth. Activity is expected to remain weak through the balance of 2005/06 but to stage a recovery in 2006/07

3.4.2. The Bank of England believes that the rebound in consumer activity, together with continued strength in public sector spending and a rise in corporate investment, will encourage higher growth in the future. This is open to debate and it is clear that the forecasting of interest rates in the current climate is difficult and a cautious approach is needed in treasury activity

3.4.3. The international economic situation creates further uncertainty in the forecast. UK longer term interest rates have been influenced by US interest rates, which currently appear unrealistically low, and there continues to be risk of an upward shift in rates. The exact timing of this is however difficult to predict.

3.5. Medium-Term Rate Forecasts – Annual Averages %

Percent	Base Rate	5-year Gilt	20-yr Gilt
2005/06	4.6	4.3	4.5
2006/07	4.3	4.4	4.6
2007/08	4.5	4.6	4.7
2008/09	4.8	4.8	4.7

3.5.1. There are significant risks to the forecast, which expects positive but low world and UK economic growth. Further weakness in growth could see short and longer term rates return to historic lows; although there is a higher probability within the forecast that rates will return to historic norms and shift to a higher level.

3.6. Borrowing and Debt Strategy 2006/07 – 2008/09

3.6.1. The growing uncertainty over future interest rates increases the risks associated with treasury activity. As a result the Council will take a cautious approach to its treasury strategy.

3.6.2. Long-term fixed interest rates are expected to rise modestly and base rates are expected to fall initially by ¼% before rising again in 2007/08. The Director 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.

3.6.3. The expected increase/ (decrease) in borrowing requirement is:

	2005/06 Revised	2006/07 Estimated	2007/08 Estimated	2008/09 Estimated
Movement in CFR	648	(410)	(517)	(496)
Maturing Debt	0	(29,884)	0	0
Total borrowing need	648	(30,294)	(517)	(496)

3.7. Investment Strategy 2006/07 – 2008/09

3.7.1. 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.

3.7.2. The Director 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. These criteria are separate to those that choose 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-**
    - **Individual / Financial Strength – C**
    - **Support – 3**
- **Bank Subsidiary and Treasury Operations** – the Council will use these where the parent bank has the necessary ratings outlined above.
- **Building Societies** – the Council will use all Societies with assets in excess of £1bn.
- **Money Market Funds** – AAA
- **UK Government** (including gilts and the DMO)
- **Local Authorities, Parish Councils etc**
- **Supranational institutions**

3.7.3. The time limits for institutions on the Council's Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):

	Fitch	Moody's	Standard & Poors	Money Limit	Time Limit
Upper Limit Category	F1+ / AA-	P-1 / A1	A-1+ / AA-	£5m	3yrs
Middle Limit Category	F1 / A-	P-2 / Baa2	A-1 / A	£3m	2yrs
Lower Limit Category	Unrated	Unrated	Unrated	£1m	3 months
Other Institution Limits	-	-	-	£5m	3yrs

3.7.4. The proposed criteria for Specified and Non-Specified investments are shown in Appendix A for approval.

3.7.5. In the normal course of the council's cash flow operations it is expected that both Specified and Non-specified investments will be utilised for the control of liquidity as both categories allow for short term investments. The Council will maintain a minimum £3m of investments in specified investments.

3.7.6. The use of longer term instruments (greater than one year from inception to repayment) will fall in 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 at Para 3.1 above.

3.7.7. Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of falling by ¼% in early 2006 and potentially rising again in 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 Director 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.

3.8. Treasury Management Prudential Indicators and Limits on Activity

3.8.1. The treasury prudential indicators are summarised in section 3.1. 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

3.9. Performance Indicators

3.9.1. 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. Examples of performance indicators often used for the treasury function are:

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

3.9.2. The results of these indicators will be reported in the Treasury Annual Report for 2005/06.

3.10. Local Issues

3.10.1. The proposed LSVT of Housing to Derwentside Homes will have a major impact on the following areas

- The Authority's Capital Programme
- The Council's Debt and Investment Portfolio
- General Fund Debt Charges and Investment Income

3.10.2. As a consequence of the proposed Housing transfer, all attributable HRA debt will be transferred to Derwentside Homes and the outstanding loans and associated premia repaid by ODPM.

3.10.3. The Director of Finance is carrying out a detailed review of the Authority's Treasury position with the Council's Treasury Management consultants to establish the implications of the transfer for future borrowing requirements, investment income, debt charges and potential early redemption opportunities.

3.11. Investment Strategy

Appendix A covers the detailed Investment Strategy for the Council

4. RECOMMENDATIONS AND REASONS

4.1. It is recommended that the Council: -

4.1.1. Note the Prudential Indicators and limits within the report

4.1.2. Approve the treasury management strategy 2006/07 – 2008/09

4.1.3. Approve the investment strategy 2006/07 contained in the treasury management strategy, and the detailed criteria included in Appendix A. Specifically approving:

- The criteria for specified investments

- The criteria for non-specified investments

For further information regarding this report contact Aynsley Merritt, Accountant on ext 8375 (a.merritt@derwentside.gov.uk)

APPENDIX A

Treasury Management Practice (TMP) 1 (5) – Credit and Counterparty Risk Management

The Office of the Deputy Prime Minister issued Investment Guidance on 12th March 2004, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds which are under a different regulatory regime.

The key intention of the Guidance is to maintain the current requirement for Councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council adopted the Code on 03 November 2003 and will apply its principles to all investment activity. In accordance with the Code, the Director of Finance has produced its treasury management practices. This part, TMP 1(5), covering investment counterparty policy requires approval each year.

Annual Investment Strategy - The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of following:

- The strategy guidelines for decision making on investments, particularly non-specified investments.
- The principles to be used to determine the maximum periods for which funds can be committed.
- Specified investments the Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
- Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

The investment policy proposed for the Council is:

Strategy Guidelines – The main strategy guidelines are contained in the body of the treasury strategy statement.

Specified Investments – These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are low risk assets where the possibility of loss of principal or investment income is small. These would include investments with:

1. The UK Government (such as the Debt Management Office, UK Treasury Bills or a Gilt with less than one year to maturity).
2. Supranational bonds of less than one year's duration.

3. A local authority, parish council or community council.
4. An investment scheme that has been awarded a high credit rating by a credit rating agency.
5. A body that has been awarded a high credit rating by a credit rating agency (such as a bank or building society).

For category 4 this covers a money market fund rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.
For category 5 this covers bodies with a minimum rating of F1 (or the equivalent) as rated by Standard and Poor's, Moody's or Fitch rating agencies. Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies which will be invested in these bodies. This criteria is……

	Fitch	Moody's	Standard & Poors	Money Limit
Upper Limit Category	F1+	P-1	A-1+	£5m
Middle Limit Category	F1	P-2	A-1	£3m
Lower Limit Category	Unrated	Unrated	Unrated	£1m
Other Institution Limits	-	-	-	£5m

Non-Specified Investments – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non specified investments would include any sterling investments with:

	Non Specified Investment Category	Limit (£ or %)
a.	**Supranational Bonds greater than 1 year to maturity** **(a) Multilateral development bank bonds** - These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Investment Bank etc.). **(b) A financial institution that is guaranteed by the United Kingdom Government** (e.g. The Guaranteed Export Finance Company {GEFCO}) The security of interest and principal on maturity is on a par with the Government and so very secure, and these bonds usually provide returns above equivalent gilt edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£5m £5m
b.	**Gilt edged securities** with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal	£5m

	on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	
c.	**Building societies not meeting the basic security requirements under the specified investments**. The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings.	£5m
d.	Any **bank or building society** that has a minimum long term credit rating of A- or equivalent, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	£15m
e.	Any **non rated subsidiary** of a credit rated institution included in the specified investment category. These institutions will be included as an investment category subject to guarantee from the parent company.	£5m
f.	**Share capital or loan capital** in a body corporate – The use of these instruments will be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. Revenue resources will not be invested in corporate bodies.	£5m

Within categories c, d and e, and in accordance with the Code, the Council has developed additional criteria to set the overall amount of monies which will be invested in these bodies. These criteria are:-

c) Building societies not meeting the basic security requirements under the specified investments

The council may use such building societies which have a minimum asset size of £1bn, but will restrict this type of investments to £1m for up to 3 months.

d) Bank or Building Society Longer Term Deposits

It is proposed that the Council will use banks and building societies that have at least the following Fitch ratings (or equivalent)

	Limit 2 Years	Limit 3 Years
	Rating	Rating
Short Term	F1	F1+
Long Term	A-	AA-
Individual / Financial Strength	C	B
Support	3	2

e) Non-Rated Subsidiary

Bank subsidiary limits will depend on the relationship between themselves and their parent bank. If there is some form of guarantee in place, similar time limits should be adopted for the subsidiary as for the bank, but if not, then the limit should be reduced. Monetary group limits including both parent bank and relevant subsidiaries would also be used to control risk.

Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies which will be invested in these bodies. This criteria is as follows: -

Short Term – F1+ (or equivalent from Moody's and Standard & Poors) total investment limit of £5m up to 3 years.

Short Term – F1 (or equivalent from Moody's and Standard & Poors) total investment limit of £3m up to 2 years.

The Monitoring of Investment Counterparties - The credit rating of counterparties will be monitored regularly. The Council receives credit rating advice from its advisers, Butlers, on a daily basis as and when ratings change, and counterparties are checked promptly On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Director of Finance, and if required new counterparties which meet the criteria will be added to the list.