REPORT TO CABINET

15th February 2007

REPORT OF DIRECTOR OF RESOURCES

Portfolio: STRATEGIC LEADERSHIP

TREASURY MANAGEMENT STRATEGY 2007/08

1.0 SUMMARY

1.1 The Treasury Management function covers the borrowing and investment activities of the Council and the effective management of associated risks in relation to these activities. This report outlines the strategy to be followed by the Council over the medium term in relation to its Treasury Management activities and takes into account guidance on investments issued by the DCLG, and the Prudential Code for Capital Finance in Local Authorities.

2.0 RECOMMENDATIONS

2.1 Following consideration of the issues set out in this report it is recommended that Cabinet make the following proposals to Council: -

- To approve the Treasury Management Strategy 2007/08;
- To approve the Investment Strategy 2007/08;
- To adopt the Prudential Indicators and Limits 2007/08 to 2009/10;
- To approve the 'Authorised Limit' for borrowing as shown in Appendix B.

3.0 TREASURY MANAGEMENT STRATEGY 2007/08

Background

3.1 The Treasury Management Service is an important part of the overall financial management of the Council's affairs. Its importance has increased as a result of the publication of the Prudential Code for Capital Finance in Local Authorities by the Chartered Institute of Public Finance and Accountancy.

3.2 Treasury Management activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). The Council initially adopted a Local Code of Treasury Management Activities in December 2002, subsequently revised by Council in September 2005, taking into account the Code of Practice and as a result adopted a Treasury Management Policy Statement. This adoption complies with one of the requirements of the CIPFA Code of Practice.

3.3 The Council's Constitution requires an annual strategy to be reported to the Council outlining the expected Treasury activity prior to commencement of the new year. A further report will be produced after the year-end showing the actual activity for the previous financial year.

3.4 A key requirement is to explain both the risks, and the management of the risks, associated with the Treasury Management activities.

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 ODPM guidance).
- Local Treasury Management Indicators. (set out in Appendix B)

Current Treasury Position

3.5 The Council's detailed Treasury position is highlighted in the following table:-

Actual	*Actual 31.03.06 £m*	*Average Rate %*	*Estimate 31.03.07 £m*	*Average Rate %*
FIXED RATE DEBT				
Public Works Loan Board				
Annuity	0.98	7.22	0.95	7.23
Maturity	17.37	6.33	17.37	6.33
Other Loans				
Annuity	0.33	7.80	0.32	7.82
	18.68	6.40	18.64	6.38
INVESTMENTS				
Various Banks & Building Societies	(28.58)	4.80	(24.50)	5.00
NET POSITION	(9.90)		(5.86)	

3.6 As the above table shows, loan debt is expected to fall slightly during the current year from £18.68m to £18.64m. Investments are also expected to fall by £4.08m from £28.58m to £24.50m. This results in a reduction in the net position (i.e. investments less borrowing) by £4.04m to £5.86m at 31st Match 2007.

Expected Movement in Interest Rates

3.7 The Council engages Butlers as its Treasury Management Consultants, to advise on the Treasury Strategy, to provide economic data and interest rate forecasts, to assist in planning and reduce the impact of unforeseen adverse interest rate movements.

3.8 In Butlers view, the Bank of England remains concerned that domestically generated inflation could strengthen in the months ahead and increase the Consumer Price Index (CPI) to unacceptably high levels. There are a number of relationships within the economy that impact on this:

- Buoyancy of international economy and the effect this might have upon domestic UK growth (paragraph 3.9)
- The strength of domestic activity and the amount of spare capacity in the economy (paragraph 3.10)
- The state of the labour market (paragraph 3.11)
- The strength of domestic demand and the pricing power of companies (paragraph 3.12).

3.9 Economic growth has been strong in 2006 and this has placed upward pressure upon materials and manufacturer's costs. However, the strength of sterling on the foreign exchanges has lessened the impact on the UK.

3.10 In Butlers view, UK growth has been stronger than expected this time last year. This has been driven mainly by domestic factors, particularly the buoyancy of consumer spending. While the current rise in official interest rates may lead to some slow down in growth, this is expected to be modest.

3.11 The Bank of England believes that the strength of UK growth for much of the last decade has reduced the amount of spare capacity in the economy to a low level. The relationship between the Retail Price Index (RPI) (now rising at an annual rate of 3.7%) and pay settlements has been strong in the past, although the relationship has weakened in recent years. The state of the labour market will dictate the extent to which pay settlements reflect the strength of the RPI and will have a major bearing upon the Bank of England's approach in early 2007.

3.12 Spending has been stronger than expected in 2006, partly as a result of increases in asset values (houses and shares). To date this has not led to a major rise in prices as competitive forces have remained strong (the influence of cheap imports) and the public being highly selective in their spending intentions (waiting for the sales).

3.13 As a result of the above economic forecast, Butlers see the expected movement in interest rates as follows:-

	Average Base Rate (%)
2005/06 (Actual)	4.6
2006/07	4.8
2007/08	**5.3**
2008/09	5.0
2009/10	4.8

This anticipates that the current Bank of England base rate, which stands at 5.25% could increase by another 0.25% before returning to 5.0% at the end of the financial year. 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, not least the possibility that the recent annual increase in RPI of close to 4% could create problems in forthcoming pay round negotiations.

Borrowing and Debt Strategy

3.14 The Prudential Code frees Local Authorities from central controls over the level of their borrowings. Previously, borrowing allocations issued by Government were used to control each authority. In recent years the Council has not needed to incur additional borrowing to finance the capital programme, instead utilising capital receipts, external grants and contributions and funding directly from revenue. However, the introduction of the Prudential Code creates an opportunity to consider alternative means of funding the capital programme, as long as they are affordable, prudent and sustainable.

3.15 Any financing costs of increased borrowing or leasing will have to be met within existing revenue budgets and therefore the Council will need to continue to take a prudent and cautious approach to its borrowing and debt strategy. This will include taking advice on the movement in interest rates and the relative costs of the alternative forms of capital financing. There are currently no plans to utilise prudential borrowing for the 2007/08 Capital Programme.

3.16 Debt restructuring opportunities will continue to be examined to reduce the Councils long term financing costs. Rates will be continually monitored throughout the year in order to take advantage of any opportunity in favourable movements.

Investment Strategy 2007/08

3.17 The ODPM issued investment guidance in March 2004 which applies to the financial year 2004/05 onwards. In common with the relaxation of borrowing controls in the prudential system, the more flexible guidance replaces the former detailed prescriptive regulations.

3.18 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 the 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 in December 2002, subsequently revised it in September 2005, and continues to apply its principles to all investment activity.

3.19 This annual investment strategy states which investments the Council may use for the prudent management of its balances during the financial year under the heading of specified and non-specified investments. These are explained and listed in Appendix A along with proposed criteria for specified and non-specified investments. There are no proposed changes to the lists approved by Members last year.

3.20 The credit rating of counterparties (banks and institutions that the Council is prepared to invest in) will be monitored on a regular basis. The Council receives credit rating advice from Butlers on a daily basis and when ratings change, and counterparties are reviewed on an ongoing basis.

3.21 In the normal course of the Council's cashflow it is expected that both specified and non-specified investments will be utilised as both categories allow for short term investments. The Council will maintain a minimum of £5m of investments in specified investments to provide it with the flexibility to meet any short term cash outflows.

3.22 The use of longer term investments (greater than 364 days) will fall in the non-specified investment category. These instruments will only be used when the Council's investment requirements are safeguarded and therefore only organisations with a high security rating will be used for these investments.

Risk Issues

3.23 Expectations are that shorter term interest rates, on which investment decisions are based, will remain relatively stable during 2007/08. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and Butlers own forecasts. It is likely that investment decisions will be for longer periods with fixed investment rates to lock into good value and security of return. The Director of Resources, using 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 above.

Local Treasury Management Indicators

3.24 The Local Code requires the Council to set performance indicators to assess the adequacy of the Treasury Management function over the next three years. These are distinct historic indicators, as opposed to the Prudential Indicators, which are predominantly forward looking.

	2007/08 %	*2008/09 %*	*2009/10 %*
DEBT			
Average Rate Movement Year on Year	- 0.10	- 0.10	- 0.10
INVESTMENTS			
Return compared with the 7 day LIBID Rate	+ 0.10	+ 0.10	+ 0.10

3.25 In effect, what these performance indicators mean is that we plan to manage our affairs so that the average rate of interest paid on external borrowings will fall by 0.10% per annum over the next three years, whilst our investment returns will exceed the industry standard benchmark (the 7 day LIBID rate) by 0.1%. Actual performance against these indicators will be reported in the respective Annual Reports for those years. The target for reducing the rate of interest on debt has changed from the previous year from a figure of - 0.20% to – 0.10%. This is because the majority of the Council's debt is at fixed rates and there has already been significant restructuring of the debt portfolio in recent years to reduce the average rate where it has been economic to do so. There is little further scope at this point in time to secure further reductions in the average rate, although the situation will be continuously monitored to take advantage of opportunities arising from fluctuations in market interest rates.

Prudential Indicators and Limits 2007/08 to 2009/10

3.26 The Prudential Code sets out a framework of self-regulation of capital spending, in effect allowing Councils to invest in capital projects as long as they are affordable, prudent and sustainable.

3.27 In general terms, the Council complies with the Prudential Code by:

- Having medium term plans (Medium Term Financial Plan, Corporate Capital Strategy, Revenue and Capital Budgets);
- Having plans to achieve sound capital investment (Capital Strategies, Capital Project Appraisals and Asset Management Plans);
- Complying with the Treasury Management Code of Practice.

3.28 To support capital investment decisions, the Prudential Code requires the Council to agree and monitor a number of Prudential Indicators. The purpose of the indicators is to provide a framework for capital expenditure controls. It highlights through the indicators the level of capital expenditure, the impact on borrowing and investment levels and the overall controls in place to ensure that spending remains affordable, prudent and sustainable.

The specific indicators that Council is asked to approve are shown in Appendix B alongside the Treasury Management Indicators.

4.0 RESOURCE IMPLICATIONS

4.1 The financial implications have been summarised at each stage of this report and have been taken into account in the preparation of the Budget Framework 2007/08 and the Medium Term Financial Plan (MTFP) 2006/07 to 2008/09. The MTFP will be fully reviewed during 2007/08 following the outcome of the Comprehensive Spending Review by the Government.

5.0 CONSULTATION

5.1 Consultation on the spending proposals contained in the Budget Framework 2007/08 has been undertaken including the involvement of the Council's Overview and Scrutiny Committees. The Council's Audit Committee at its meeting on 29th January also considered the Strategy and recommended its acceptance by Cabinet and the Council. The Council's treasury consultants have also been consulted in the preparation of this Treasury Strategy

6.0 OTHER MATERIAL CONSIDERATIONS

6.1 Links to Corporate Objectives/Values

The proposals contained in the report support the Council's corporate value of being responsible with and accountable for public finances. The Council's Treasury Management Strategy supports the effective management of its debt and investment portfolio within a framework that ensures that it is responsible for public finances. The reporting of this strategy and the requirement to obtain formal approval for its implementation demonstrates accountability.

6.2 Risk Management

Treasury management activities are comprehensively governed by professional codes of practice and regulations surrounding borrowing and debt management. The Council approved a revised code of treasury management practices in September 2005, which provides full details of how risk is assessed, managed and mitigated. In particular, Treasury Management Practice 1 (TMP1) deals specifically with the design, implementation, and monitoring of arrangements for identification, management and control of treasury management risk, which will govern the implementation of this strategy.

6.3 Health and Safety

There are no significant health and safety implications arising from this report.

6.4 Equality and Diversity

There are no significant equality and diversity issues arising from this report.

6.5 Legal and Constitutional

Arrangements surrounding the management and reporting of the Council's treasury management activities are contained in the Council's constitution and this report complies with those requirements. No new implications are identified in this report.

7.0 OVERVIEW AND SCRUTINY IMPLICATIONS

7.1 As mentioned above, full consultation and engagement on the Council's budget proposals has been made with all three Overview and Scrutiny Committees.

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BACKGROUND PAPERS

1. CIPFA Code of Practice on Treasury Management.
2. Local Code of Treasury Management Activities – Report to Council, December 2002
3. Prudential Code for Capital Finance in Local Authorities.
4. Review of the Local Code of Treasury Management Practice – Report to Council, 30.09. 2005
5. Treasury Management Strategy 2007/08 report to Audit Committee, January 2007

EXAMINATION BY STATUTORY OFFICERS

	YES	NOT APPLICABLE
1. The report has been examined by the Council's Head of the Paid Service or his representative	✓	
2. The content has been examined by the Council's S151 Officer or his representative.	✓	
3. The content has been examined by the Council's Monitoring Officer or his representative	✓	
4. The report has been approved by Management Team.	✓	

ANNUAL INVESTMENT STRATEGY
Schedule of Specified and Non-Specified Investments

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

Specified Investment Category	Credit Rating	Max Period
UK Government – including Debt management Office, UK Treasury Bills or gilts with less than one year to maturity	High security. No Credit rating criteria needed.	1 year
Supranational Bonds – 1) issued by a financial institution that is guaranteed by the UK 2) multi lateral development bank bonds aimed at economic development (e.g. European Investment Bank)	High security. No Credit rating criteria needed	1 year
Local Authority, Parish or Community Council	High security. No Credit rating criteria needed	1 year
Money Market Funds (Investment Schemes)	AAA rating by Fitch, Moody's and Standard and Poors	1 year
Highly Credit Rated Body – investments made with a bank/building society from the Council's counterparty list	Short term rating of at least F1 (or equivalent)	1 year

Non - Specified Investments
Non –specified investments are any other type of investment (i.e. not defined as specified investments 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 Investment Category	Limit (£)
Supranational Bonds greater than 1 year to maturity – 1) issued by a financial institution that is guaranteed by the UK 2) multi lateral development bank bonds aimed at economic development (e.g. European Investment Bank)	£15m
Gilt edged securities greater than 1 year to maturity – Government bonds providing the highest level of security.	£15m
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 £200m .	£15m
Any **Bank or Building Society** that has a minimum long term credit rating of A- for deposits of greater than one year (including forward deals in excess of one year from inception to repayment)	£15m
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 a guarantee from the parent company.	£3m
Share capital or loan capital in a body corporate – the use of these instruments will count as capital expenditure and will be an application of capital resources. Revenue resources will not be invested in corporate bodies.	£3m

TREASURY MANAGEMENT INDICATORS

The purpose of these Prudential Indicators is to contain the activity of the Treasury Management function within certain limits, thereby reducing the risk or likelihood of an adverse movement in interest rates or borrowing decisions, impacting negatively on the Council's overall financial position. Four Prudential Indicators are required under this category:-

Upper Limits on Fixed Interest Rate Exposure
This indicator provides the range within which the authority will manage its exposure to fixed rates of interest.

Upper Limits on Variable Interest Rate Exposure
This indicator provides the range within which the authority will manage its exposure to variable rates of interest.

Maturity Structure of Fixed Borrowing
This indicator measures the amount of fixed rate borrowing maturing at each period expressed as a percentage of total borrowing at fixed rate at the start of each period.

Maximum Principal Sums Invested for more than 1 year
The purpose of this indicator is to contain the exposure to the possibility that loss might arise as a result of seeking early repayment or redemption of sums invested, or exposing public funds to unnecessary or unquantified risk.

The Council is asked to approve these indicators, which have been calculated as follows:

Treasury Indicators	*2007/08 to 2009/10 % of debt*
Upper Limits on Fixed Interest Rates	100%
Upper Limits on Variable Interest Rates	50%
Maturity Structure of Fixed Borrowing	
Under 12 months	50%
12 months to 2 years	50%
2 years to 5 years	50%
5 years to 10 years	50%
10 years and above	100%
Upper Limit on Principal Sums Invested for more than 1 year	£25m

CAPITAL EXPENDITURE AND THE CAPITAL FINANCING REQUIREMENT

Capital Expenditure

This indicator shows the overall capital spending plans of the Council over the medium term and reflects planned investment levels in line with the Medium Term Financial Plan. The actual capital expenditure that was incurred in 2004/05 and the estimates of capital expenditure to be incurred for the current and future years that are recommended for approval are:

Capital Expenditure	*2005/06 Actual £'000*	*2006/07 Est Outturn £'000*	*2007/08 Budget £'000*	*2008/09 Estimated £'000*	*2009/10 Estimated £'000*
Housing	7,211	9,000	8,400	8,000	8,000
Non-Housing	7,882	7,800	11,600	12,000	12,000
Total	**15,093**	**16,800**	**20,000**	**20,000**	**20,000**

Capital Financing Requirement (CFR)

This figure represents the Council's underlying need to borrow for a capital purpose, and the change year on year will be influenced by the capital expenditure in the year and how much of this is supported directly through grants, contributions and capital receipts. The CFR is essentially a replacement of the former 'credit ceiling' mechanism, which was also a measure of underlying borrowing need.

The Council's expectations of the CFR in the next three years that Council is asked to approve are as follows:

Capital Financing Requirement	*2005/06 Actual £'000*	*2006/07 Est Outturn £'000*	*2007/08 Budget £'000*	*2008/09 Estimated £'000*	*2009/10 Estimated £'000*
Housing	9,714	9,927	10,140	10,340	10,540
Non-Housing	9,433	9,056	8,694	8,346	8,012
Total CFR	**19,147**	**18,983**	**18,834**	**18,686**	**18,552**

LIMITS TO BORROWING ACTIVITY

Net Borrowing

The first key control over the Council's activity is to ensure that over the medium term net borrowing will only be for a capital purpose. The Council needs to ensure that net external borrowing does not, except in the short term, exceed the CFR in the preceding year plus the estimates of any additional capital financing requirement for the following three years.

Notwithstanding the above, there is currently a gap between the CFR and Gross Borrowing and the Director of Resources will consider limited borrowing opportunities within this narrow band where it is in the Council’s financial interests.

The Council is asked to approve the following borrowing limits, which take into account current commitments, existing plans and the proposals in the Budget Framework:-

Net Borrowing	*2005/06 Actual* *£'000*	*2006/07 Est Outturn* *£'000*	*2007/08 Budget* *£'000*	*2008/09 Estimated* *£'000*	*2009/10 Estimated* *£'000*
Gross Borrowing	18.679	18.640	18.600	18.556	18.509
Investments	(28.580)	(24.500)	(31.000)	(25.000)	(19.000)
Net Borrowing	**(9.901)**	**(5.860)**	**(12.400)**	**(6,444)**	**(491)**

A further two prudential indicators control the overall level of borrowing*:* **Authorised Limit** and the **Operational Boundary**. These limits separately identify borrowing from other long-term liabilities such as finance leases. Net borrowing is expected to increase over time as capital receipts are used to finance the capital programme, which means that they are no longer available for investment purposes.

Authorised Limit
This represents the limit beyond which borrowing is prohibited and reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need with some headroom for unexpected movements. <u>This is a statutory limit that the Council must determine in accordance with Section 3(1) of the Local Government Act 2003.</u>

The Council is asked to approve the following authorised limits:

Authorised Limit	*2005/06 Actual* *£'000*	*2006/07 Est Outturn* *£'000*	*2007/08 Budget* *£'000*	*2008/09 Estimated* *£'000*	*2009/10 Estimated* *£'000*
Borrowing	30,000	30,000	30,000	30,000	30,000
Long Term Liabilities	-	-	-	-	-
Total	**30,000**	**30,000**	**30,000**	**30,000**	**30,000**

Operational Boundary
This indicator is based on the probable external debt during the course of the year; it is not a limit and actual borrowing could vary around this boundary for short times during the year. It should act as an indicator to ensure that the authorised limit is not breached.

The Council is asked to approve the following operational limits:

Operational Boundary	*2005/06 Actual* *£'000*	*2006/07 Est Outturn* *£'000*	*2007/08 Budget* *£'000*	*2008/09 Estimated* *£'000*	*2009/10 Estimated* *£'000*
Borrowing	22,000	22,000	22,000	22,000	22,000
Long Term Liabilities	-	-	-	-	-
Total	**22,000**	**22,000**	**22,000**	**22,000**	**22,000**

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 Council's overall finances.

The Council is asked to approve the following indicators:

Ratio of Financing Costs to Net Revenue Stream
This indicator expresses the amount of interest payable on external debt and other debt management expenses (i.e. financing costs) as a proportion of the amount of income received from Government and local taxpayers (i.e. net revenue stream). The definition of net revenue stream for the HRA is based on the statutory definition which incorporates charges to the account under Part 4 of the Local Government and Housing Act 1989.

Financing Costs to Net Revenue Stream	*2005/06 Actual*	*2006/07 Est Outturn*	*2007/08 Budget*	*2008/09 Estimated*	*2009/10 Estimated*
Housing	44.8%	40.5%	39.6%	30.2%	30.2%
Non-Housing	0.5%	(1.0%)	(2.8%)	(2.8%)	(2.8%)

Incremental Impact of Capital Investment Decisions on Council Tax and Housing Rents

As the Council's capital programme is financed by Government allocations, external funding from partners, and from the Council's own resources, such as capital receipts, there is no requirement for the Council to borrow to finance its capital investment over the medium term. As a consequence there are no additional financing charges to be absorbed by both the General Fund and Housing Revenue Accounts over this period. This is reflected in the following two indicators, which show the impact on Council Tax and Housing Rents.

This indicator identifies the impact of the Council's General Fund Capital Programme on revenue budgets and is expressed in terms of Band D Council Tax.

Incremental Impact of Capital Programme	*2007/09 Proposed Budget*	*2008/09 Projection*	*2009/10 Projection*
Council Tax at Band D	£0.00	£0.00	£0.00

Similar to the Council Tax calculation this indicator identifies the impact of the Housing Capital Programme on revenue budgets, expressed in terms of weekly rent levels.

Incremental Impact of Capital Programme	*2007/08 Proposed Budget*	*2008/09 Projection*	*2009/10 Projection*
Weekly Housing Rent	£0.00	£0.00	£0.00