TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY 2005/2006

1 SUMMARY

1.1 This reports sets out the Council's treasury strategy for borrowing and investments for 2005/2006 and updates the borrowing strategy for 2004/05.

2 INTRODUCTION

2.1 The Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

2.2 The Act therefore requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy; this sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

2.3 The guidance from the Office of the Deputy Prime Minister (ODPM) states that authorities can combine the Treasury Strategy Statement and Annual Investment Strategy into one report; the Council has adopted that suggestion and the Annual Investment Strategy is therefore included as paragraph 11.

2.4 The suggested strategy for 2005/06 in respect of the following aspects of the treasury management function is based upon the financial officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor, Sector Treasury Services Limited (Sector).

2.5 The strategy covers: -

- treasury limits in force which will limit the treasury risk and activities of the Council;
- Prudential Indicators
- the current treasury position;
- the borrowing requirement
- prospects for interest rates;
- the borrowing strategy;
- debt rescheduling;
- the investment strategy;

3 ANNUAL TREASURY MANAGEMENT STRATEGY FOR 2004/05

3.1 The Strategy for 2004/05 was agreed by Council on 24th February 2004 and included no requirement for prudential borrowing in this financial year. The Strategy had to be agreed before the start of the financial year and was based on the latest information regarding supported capital expenditure.

3.2 With the introduction of the Prudential Framework, credit approvals for capital expenditure have been replaced by revenue support. After the Strategy was agreed, the Council received confirmation that the Housing Revenue Account would receive revenue support of £7,000 part year to be used only towards the cost of borrowing for capital investment. It is therefore recommended that the best use of this revenue support would be for the Housing Revenue Account to undertake prudential borrowing of £331,000.

3.3 For Members to agree this course of action, the Prudential Code requires that they consider the effect of this borrowing on the prudential indicator for affordability, which is the estimate of the incremental impact on the average weekly housing rent of the capital investment decision. This decision to borrow will not affect the capital expenditure which has already been decided upon; it is a change to the financing arrangements. As the cost of the borrowing will be met from the revenue support there will be a zero impact on the weekly housing rent.

3.4 The timing and terms of the borrowing will be agreed by the Corporate Director (Finance & External Services) based on the advice of our Treasury Management consultants.

4 TREASURY LIMITS FOR 2005/06

4.1 It is a statutory duty under S.3 of the Local Government Act 2003 and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the "Affordable Borrowing Limit".

4.2 The Council must have regard to the Prudential Code when setting the Affordable Borrowing Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax and council rent levels is 'acceptable'.

4.3 Whilst termed an "Affordable Borrowing Limit", the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The affordable borrowing limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.

5 PRUDENTIAL INDICATORS FOR 2005/06 – 2007/08

5.1 The following prudential indicators are relevant for the purposes of setting an integrated treasury management strategy. The Indicators in Table 1 will also appear in the Budget setting report, with more detailed explanation.

TABLE 1 - BUDGET AND RENT SETTING PRUDENTIAL INDICATORS	2003/04	2004/05	2005/06	2006/07	2007/08
	actual	probable outturn	estimate	estimate	estimate
Capital Expenditure	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Non - HRA	1,735	2,859	4,665	736	381
HRA	1,326	1,402	1,149	1,168	1,187
TOTAL	2,471	4,261	5,814	1,904	1,568
	£	£	£	£	£
Incremental Impact on Council Tax (per Band D)	**(0.87)**	**0.31**	**0.64**	**0.60**	**0.06**
Incremental Impact on Housing Rents (per property)	**(2.89)**	**1.36**	**(3.29)**	**(2.46)**	**0.00**
Ratio of financing costs to net revenue stream					
Non - HRA	(5%)	(4%)	(4%)	(4%)	(4%)
HRA (applies only to housing authorities)	22%	22%	22%	20%	19%
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
Net New borrowing requirement	0	331	2,698	0	0
Capital Financing Requirement as at 31 March	10,209	10,457	13,505	13,505	13,505
Affordable Borrowing Limit	11,573	11,550	14,240	13,880	13,530

TABLE 2. TREASURY MANAGEMENT PRUDENTIAL INDICATORS	2003/04	2004/05	2005/06	2006/07	2007/08
	actual	probable outturn	estimate	estimate	Estimate
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
Authorised limit for external debt -					
Borrowing (includes overdraft to cover risk of interrupted cashflows)	11,797	15,000	17,850	17,820	17,820
other long term liabilities	169	110	90	70	70
TOTAL	11,966	15,110	17,940	17,890	17,890
Operational boundary for external debt -					
Borrowing	11,573	11,550	14,240	13,880	13,530
other long term liabilities	169	110	90	70	50
TOTAL	11,742	11,660	14,330	13,950	13,550
Upper limit for fixed interest rate exposure					
Net principal re fixed rate borrowing / investments	**11,500**	**11,700**	**14,300**	**13,800**	**13,600**
Upper limit for variable rate exposure					
Net principal re variable rate borrowing/investments	**18,000**	**20,000**	**20,000**	**20,000**	**20,000**
Upper limit for total principal sums invested for over 364 days	2,000	2,000	2,000	2,000	2,000

Maturity structure of new fixed rate borrowing during 2005/06	upper limit	lower limit
under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

5.2 The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. This was adopted on 19 December 2002 by the full Council.

5.3 **Current Portfolio Position**

The Council's treasury portfolio position at 31 December 2004 comprised:

	Balance £m	Average Rate %
Fixed Rate Loans - PWLB Principal	11.04	9.66
Variable Rate Loans	-	-
Investments	14.0	4.92

5.4 **Borrowing Requirement**

	2003/04	2004/05	2005/06	2006/07	2007/08
	actual	probable outturn	estimate	estimate	estimate
	£'000	£'000	£'000	£'000	£'000
New Borrowing	-	331	3,048	350	350
Alternative financing arrangements	-	-	-	-	-
Replacement borrowing	-	-	-	-	-
TOTAL	-	331	3,048	350	350

5.5 In addition to the new borrowing for the Rayleigh Leisure Centre in 2005/06 of £2.698m, the Government have confirmed that we will receive revenue support funding for the next 3 years and it is therefore intended that £350,000 will be borrowed each year to support the Housing Revenue Account capital programme. Apart from this new borrowing, it is not anticipated that it will be necessary to undertake any other borrowing to finance the capital programme, although temporary short-term borrowing may have to be undertaken for cash flow purposes.

5.6 **Prospects for Interest Rates**

The Council has appointed Sector Treasury Services as treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. Sector have provided the following forecasts, with the base rate still expected to rise to 5.00% in Quarter 1 2005 as it nears the peak of the cycle and is then expected to fall back in 2005:

	Q/E4 2004 %	Q/E1 2005 %	Q/E2 2005 %	Q/E3 2005 %	Q/E4 2005 %	Q/E1 2006 %	Q/E2 2006 %	Q/E3 2006 %	Q/E4 2006 %	Q/E1 2007 %	Q/E2 2007 %	Q/E3 2007 %
Base Rate	4.75	5.00	5.00	4.75	4.75	4.50	4.50	4.25	4.25	4.25	4.50	4.50
10 yr PWLB Rate	5.00	5.00	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75
25 yr PWLB Rate	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75

5.7 **Borrowing Strategy**

Sector's view is that there is not likely to be much difference between short-term variable PWLB rates and medium and long-term PWLB fixed rate borrowing during 2005/06 provided base rate falls from 5.0% to 4.75% as expected in quarter 3 of 2005. Variable rate borrowing will therefore be slightly more expensive than long term fixed borrowing during quarter 2, but is expected to become cheaper in quarter 1 of 2006 when base rate is forecast to fall to 4.5%. Thereafter variable rate borrowing is expected to become still cheaper during 2006 and so the gap will widen further between long term fixed and variable rates.

5.8 Long-term rates are not currently expected to move significantly in 2005/06 but may drift to the downside.

5.9 These interest rate expectations provide a variety of options:

- that short-term variable rates will be good value compared to long-term rates, and are likely to remain so for potentially at least the next couple of years. Best value will therefore be achieved by borrowing short term at variable rates in order to minimise borrowing costs in the short term or to make short-term savings in order to meet budgetary constraints. If fixed PWLB rates should fall significantly, then a suitable trigger point for considering new fixed rate long term borrowing would be about 4.5%.

- that the risks intrinsic in the shorter term variable rates are such, when compared to historically relatively low long term fixed funding, which may be achievable in 2005/06, that the Council will maintain a stable, longer term portfolio by drawing longer term fixed rate funding at a marginally higher rate than short term rates.

5.10 Against this background caution will be adopted with the 2005/06 treasury operations. The Authority has identified a requirement for new borrowing of

£331,000 in 2004/05 and £2.7m in 2005/06. The timing of any borrowing or whether it will be financed from internal borrowings will be decided by the Corporate Director (Finance & External Services), who will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to Council at the next available opportunity. Advice will also be sought from Sector.

5.11 **Debt Rescheduling**

5.12 Opportunities may exist for restructuring long term debt into short term variable rate debt to produce savings later in the year, particularly once base rate has fallen to 4.5%. Long term debt rates at or above 5% would warrant reviewing the potential for undertaking debt restructuring. Any positions taken via rescheduling will be in accordance with the strategy position outlined in paragraph 9 above and following advice from Sector.

5.13 The reasons for any rescheduling to take place will include:

- the generation of cash savings at minimum risk;
- in order to help fulfil the strategy outlined in paragraph 9 above; and
- In order to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of volatility).

5.14 All rescheduling will be reported to the Council at the meeting following its action.

6 ANNUAL INVESTMENT STRATEGY

6.1 Background

6.2 Since 1990, local government investments have been subject to the Local Authorities (Capital Finance) (Approved Investments) Regulations 1990 made under Part 4 of the Local Government and Housing Act 1989. The repeal of Part 4 by the Local Government Act 2003 and the parallel revocation of the "approved investments" regulations brings this regime to an end, as part of the introduction of the new prudential capital finance system. Under the new system, the Government has removed the detailed prescriptive regulations.

6.3 Investment Policy

6.4 The Council will have regard to the ODPM's Guidance on Local Government Investments ("the Guidance") issued in March 2004 and CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities are: -

(a) the security of capital and
(b) the liquidity of its investments.

6.5 The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

6.6 The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

6.7 Investment instruments identified for use in-house in the financial year are listed below. The Council does not use a fund manager.

Term Deposits – UK Government	See below for counterparty limits
Term Deposits – Other Local Authorities	
Term Deposits – Bank and Building Societies	
Debt Management Account Deposit Facility (Government managed)	
Money Market Funds	

6.8 Under the old regime, the Council's counterparty list was agreed as part of the Annual Treasury Management Strategy. This meant that any changes to the list, arising from changes in credit ratings or the introduction of new investment instruments, required committee reports.

6.9 The Council uses Fitch ratings to derive its criteria. Where a counterparty does not have a Fitch rating, the equivalent Moody's rating will be used. All credit ratings will be monitored monthly. The Council is alerted to changes in Fitch ratings through its use of the Sector creditworthiness service.

6.10 The Corporate Director (Finance & External Services) will act on the advice received from Sector. If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately. Conversely, if an upgrade means that a counterparty falls into the Council's minimum criteria, the Corporate Director (Finance & External Services) may consider and approve its use as a new counterparty.

6.11 The approved Counterparty list will be determined by the following minimum criteria:

ORGANISATION	CRITERIA	MAX AMOUNT	MAX PERIOD
U.K. Clearing Bank & U.K. Building Society	Minimum F1+ short term backed up by AA long-term credit rating and support rating of 1 or 2	£2M	3 years
U.K. Clearing Bank & U.K. Building Society	Minimum F1 or P1 short term backed up by AAA or AA- long-term credit rating, individual rating B and support ratings of 1, 2 or 3.	£6m	364 days

ORGANISATION	CRITERIA	MAX AMOUNT	MAX PERIOD
U.K. Clearing Bank & U.K. Building Society	Minimum F1 or P1 short term backed up by A long-term credit rating, individual rating B and support ratings of 1, 2 or 3.	£3m	3 months
UK Local Authorities		£6m	364 Days
Other UK Financial Institutions & Government Bodies	Minimum F1+ short term backed up by AA+ long-term credit rating and support rating of 1	£6m	364 days
Money Market Funds	Minimum AAA long-term credit rating	£6m	364 days

6.12 Investment Strategy

6.13 The Council does not use a fund manager and the funds managed in-house are a split between those cash-flow derived and core balances. Investments will accordingly be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). Sector is forecasting base rates to be on a falling trend from 5.00% in Q1 and Q2 2005 to 4.50% in Q1 & 2 of 2006. The Council will therefore seek to lock in longer period investments at higher rates before this fall starts for some element of its investment portfolio which represents its core balances.

6.14 The Council has identified 5% (base rate + 0.25%) as an attractive trigger rate for 1-year lending and 5.5% (base rate + 0.5%) for 2-3 year lending. The 'trigger points' will be kept under review and discussed with Sector so that investments can be made at the appropriate time.

6.15 For its cash flow generated balances, the Council will seek to utilise its business reserve accounts and short-dated deposits (1-3 months) in order to benefit from the current interest rates.

6.16 At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

7 RISK IMPLICATIONS

7.1 It is necessary to outline the risks involved in the investments made by the Council. There is of course always a risk that a building society or bank may fail during the duration of an investment but this is not considered likely where the institution has a minimum credit rating as specified in our Investment Strategy. With regard to deposits for more than one year , the advantage from a treasury management point of view is that there is a known rate of return over the period that the monies are invested which aids forward planning. There is however the increased risk due to the longer time span that a) the institution fails or b) interest rates rise in the meantime. Therefore no investments for more than 1 year will be made without the advice of our Treasury Consultants on the likely movement of interest rates over the period of the proposed investment. The Council may use Money Market Funds from AAA-rated institutions for cash balances. These are funds with the highest credit rating, providing excellent security for the council's money. Surplus balances not invested in pure cash deposits can earn a rate similar to 1 month LIBID, and funds can be accessed with minimal notice. Returns are not fixed, however, and will rise and fall in line with the market. As a result, these funds will not be used to take a view on the likely future path of interest rates, or as a protection against falling rates. Their natural use is for balances too small to place with banks and building societies, or as an alternative to a bank call account. No investments will be made in Money Market Funds without the advice of our Treasury Consultants.

7.2 **Resource Risk**

Investment income is a material source of income to the Authority. The amount of income generated is dependent upon interest rates and there is always a risk of falling rates

7.3 **Strategic Risk**

The results of the Housing Stock Option Appraisal will raise a number of critical decisions which will impact on the Investment Strategy and need to be considered and planned for in advance of any physical cash transaction taking place.

7.4 **Interest Risk**

The main sensitivities of the interest rate forecasts are likely to be the two scenarios below. The Council officers, in conjunction with the treasury advisers, will continually monitor both the prevailing interest rates and the market forecasts, adopting the following responses to a change of sentiment:

- *if it were felt that there was a significant risk of a sharp rise in long and short term rates,* perhaps arising from a greater than expected increase in world economic activity, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

- *if it were felt that there was a significant risk of a sharp fall in long and short term rates,* due to e.g. growth rates remaining low or weakening, then long term borrowings will be postponed, and any rescheduling from fixed rate funding into variable or short rate funding will be exercised.

7.5 **Operational Risk**

The treasury management function cannot take place without an agreed Treasury Management Strategy in place before the start of the financial year.

7.6 **Reputation Risk**

The Authority is responsible for managing the investment of public funds and must be seen to be adopting a pragmatic and prudent approach.

7.7 **Regulatory Risk**

The treasury management function cannot take place without an agreed Treasury Management Strategy in place before the start of the financial year.

8 RESOURCE IMPLICATIONS

8.1 All interest paid and received is accounted for within the General Fund. Charges to the Housing Revenue Account are made in accordance with Government Regulations.

9 RECOMMENDATION

9.1 It is proposed that the Council **RESOLVES**

(1) To agree the Treasury Management Strategy Statement and Annual Investment Strategy including the limits contained within the report
(2) To agree that the Corporate Director (Finance & External Services) can undertake the prudential borrowing outlined in this report
(3) To agree the Authorised Limit and Operational Boundary for external debt as laid down in the report and delegate authority to the Corporate Director (Finance & External Services), within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long term liabilities.
(4) To agree the revised criteria for Counterparties and delegate to the Corporate Director (Finance & External Services) the authority to add and remove counterparties in line with this criteria.

Dave Deeks

Head of Financial Services

Background Papers:-

CIPFA Prudential Code
CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes
Local Government Act 2003
ODPM's Guidance on Local Government Investments March 2004

For further information please contact Mrs Y Woodward on:-

Tel:- 01702 546366 ext 3101
E-Mail:- yvonne.woodward@rochford.gov.uk