Agenda No 2

AGENDA MANAGEMENT SHEET

Name of Committee	**Council**
Date of Committee	**7 February 2006**
Report Title	**Treasury Management Strategy 2006/07**
Summary	This report sets out the proposed Treasury Management Strategy for 2006/07 as required by the CIPFA Code of Practice on Treasury Management.
For further information please contact:	Phil Triggs Group Manager (Treasury and Pensions) Tel: 01926 412227 philtriggs@warwickshire.gov.uk
Would the recommended decision be contrary to the Budget and Policy Framework? [please identify relevant plan/budget provision]	No.
Background papers	• CIPFA publication "Treasury Management in the Public Services: Code of Practice and Guidance notes for Local Authorities" • Office of the Deputy Prime Minister's Guidance on Local Government Investments • CIPFA publication "The Prudential Code for Capital Finance in Local Authorities" • Cabinet Report of 18 November 2004 on the Treasury Management Lending List • Treasury Management Practices (TMPs)

CONSULTATION ALREADY UNDERTAKEN when submitted to Cabinet on 2 February 2006: Details to be specified

Other Committees	☐	....
Local Member(s)	☐	
Other Elected Members	☒	Cllrs Atkinson, Booth, McCarney
Cabinet Members	☒	Cllr Cockburn – Portfolio Holder

Chief Executive	☐	....
Legal	☒	Jane Pollard – Assistant County Solicitor
Finance	☒	David Clarke – reporting officer
Other Chief Officers	☐	....
District Councils	☐	....
Health Authority	☐	....
Police	☐	....
Other Bodies/Individuals	☐	

FINAL DECISION - YES

SUGGESTED NEXT STEPS:		Details to be specified
Further consideration by this Committee	☐	....
To Council	☐	
To Cabinet	☐	
To an O & S Committee	☐	....
To an Area Committee	☐	....
Further Consultation	☐	....

Agenda No 2

Council – 7 February 2006

Treasury Management Strategy 2006/07

Report of the Strategic Director of Resources

Recommendations from Cabinet

(1) That the Treasury Management Strategy and Investment Strategy for 2006/07 be approved.

(2) That the Prudential Indicators (see **Appendix A**) are approved, subject to any changes as a result of the setting of the 2006/07 budget (*see next item*).

(3) That the delegated powers in paragraph 9 of the report are approved.

1 Introduction

1.1 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.

1.2 The Act requires the Council to set out its Treasury Management Strategy for borrowing and to prepare an Annual Investment Strategy. Such a strategy will set out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments. The Annual Investment Strategy is included in the Treasury Management Strategy for 2006/07.

1.3 The suggested strategy for 2006/07 in respect of the following aspects of the treasury management function is based upon the Strategic Director of Resources' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor. The strategy covers:

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

- delegated authority
- the investment strategy;

1.4 The County Council is required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. This was adopted on 24 January 2002 by the Cabinet.

2 Treasury Limits for 2006/07 to 2008/09

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

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

2.3 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.

3 Prudential Indicators for 2006/07 to 2008/09

3.1 The Prudential Indicators, as set out in **Appendix A** to this report, are relevant for the purposes of setting an integrated Treasury Management Strategy. The indicators are provisional and based on the currently agreed capital programme. The Prudential figures will be revised when the 2006/07 revenue and capital budgets are agreed by the County Council (see item on this agenda).

4 Projected Portfolio Position

4.1 The Council's projected treasury portfolio position at 31 March 2006 comprises:

	Principal £m	**Average Rate %**
Fixed Rate Funding		
PWLB	239.4	6.06
EIB	0.1	4.71
Total Debt	**239.5**	**6.06**
Total Investment	**118.8**	**4.78**

PWLB = Public Works Loans Board
EIB = European Investment Bank

5 Borrowing Requirement

5.1 The Council's anticipated borrowing requirement, based upon the 2006/07 to 2008/09 Capital Programme Report, to be considered by Cabinet on 2 February 2006 comprises:

	04/05 Actual £000	**05/06 Probable £000**	**06/07 Estimate £000**	**07/08 Estimate £000**	**08/09 Estimate £000**
New borrowing	29,641	31,547	20,248	20,602	7,899
Replacement borrowing	2,609	153	2,952	3,791	2,543
Total	**32,250**	**31,700**	**23,200**	**24,394**	**10,442**

6 Prospects for Interest Rates

6.1 The County Council has appointed Sector Treasury Services as its treasury advisor and part of Sector's service is to assist the County Council to formulate a view on interest rates. The following table gives Sector's central view on interest rates.

Sector View: Interest rate forecast – November 2005

	Q/E4 2005	**Q/E1 2006**	**Q/E 2 2006**	**Q/E3 2006**	**Q/E4 2006**	**Q/E1 2007**	**Q/E2 2007**	**Q/E3 2007**	**Q/E4 2007**
Base rate	4.50%	4.50%	4.25%	4.25%	4.00%	4.25%	4.50%	4.75%	4.75%
5 yr Gilt Yield	4.25%	4.00%	4.00%	4.25%	4.50%	4.75%	4.75%	4.75%	4.75%
10 yr PWLB Rate	4.50%	4.25%	4.50%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%
25 yr PWLB Rate	4.50%	4.50%	4.50%	4.50%	4.75%	4.75%	4.75%	5.00%	5.00%

Q/E = calendar quarter end

6.2 Sector is forecasting base rates to remain on hold at 4.50% until the end of Q1 2006, to fall to 4.00% by the end of Q4 2006, and then to edge up by 0.25% in Q1, Q2 and Q3 of 2007 to end the year at 4.75%.

6.3 The risk to this forecast is to the downside in as much as the cuts in rates could occur earlier than the forecast suggests, although this will not necessarily affect the timing of the first upward move in Q1 2007.

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

6.5 £34.2m of the County Council's funds are externally managed on a discretionary basis by Investec. Their view on interest rates and opportunities for gilts/bonds is as follows. The forecast investment return is superior, given their scope to invest in the gilt/bond market as well as cash certificates of deposit.

	2006/2007 %
Worst Case	4.50
Central Case	4.75
Best Case	5.00

At 21 December 2005

6.6 Sector's view of the economic background points to the UK now in the downswing of the economic cycle. GDP growth is anticipated to weaken from 3.2% in 2004 to about 1.7% in 2005 before rising to about 2.0% in 2006. There has been a marked slowdown in household spending in 2005.

6.7 House price inflation has fallen to very low levels and may now stabilise during 2006. The rise in inflation has caused some concern and high oil prices have pushed inflation up over its target level. However, this is a one off effect, which will fall out even if oil prices remain at current levels. There remains concern that the public sector deficit will exceed its target significantly and lead to an increase in taxation.

6.8 A boom in world commodity prices driven by strong growth in China and India will result in potential for further increases in prices but increases in overall supply and improvements in technology are likely to reduce prices in the medium term. The inability of oil producers to spend their huge cash surpluses and the reluctance of Asian economies to run current account deficits will suppress world demand and dampen world growth.

6.9 In the US, there has been a continuation of measured interest rate raising by the Federal Reserve, coupled with concerns about rising inflation. The Federal Reserve rate may now peak at 4.5%. US GDP growth is expected to weaken from 4.4% in 2004, to 3.4% in 2005 and to 2.5% in 2006.

6.10 The European Central Bank (ECB) has held the repo rate at 2.00% since June 2003 and this is likely to continue for a while but with a risk to the upside. European consumers lack confidence to increase their spending and GDP growth is expected to rise weakly and to continue to under-perform the UK and US economies.

Long-term 25-year Public Works Loans Board (PWLB) rate

6.11 This is expected to remain around 4.50%

7 Borrowing Strategy

7.1 The 25-30 year PWLB rate is expected to remain at 4.50% until Q3 2006 when it will rise to 4.75% and then to 5.00% in Q4 2007. The 10-year rate is expected to dip to 4.25% in Q1 2006 but will then reach 4.75% in Q3 2006 and remain there until the end of 2007. 5-year gilt yields will follow base rate down and trough by the end of Q1 2006 at 4.00%. Yields will rise to 4.25% in Q3, 4.5% in Q4 2006 and to 4.75% in Q1 2007 as the rate cycle increases.

7.2 This forecast indicates, therefore, that the borrowing strategy for 2006/07 should be set to take long-dated borrowings in the first half of the fiscal year before the PWLB rates rise. This applies particularly to the 10-year area where Sector forecasts the rate to fall to 4.25% in Q1 2006. Variable rate borrowing and borrowing in the five-year area will also be attractive in the first half of the fiscal year while the repo rate is on a falling trend.

7.3 These interest rate expectations provide a variety of options:

- Short-term variable rates will be good value compared with 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.

- However, 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 2006/07, 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.

7.4 Against this background, caution will be adopted with the 2006/07 treasury operations. The Strategic Director of Resources will monitor the interest rate market and adopt a pragmatic approach dependent on circumstances.

7.5 The main sensitivities of the forecast 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 or from increases in inflation, then the portfolio position will be reappraised 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, e.g., due to 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.

8 Debt Rescheduling

8.1 Opportunities may exist for restructuring long-term debt into short-term variable rate debt to produce savings later in the year, particularly once the base rate has fallen to 4.25%. Long term fixed rates are not expected to rise back above 5.00% during 2006/07. Consequently, long-term debt rates at or above 4.75% would warrant a review of the potential for undertaking debt restructuring. Any positions taken via rescheduling will be in accordance with the strategy position outlined in section 7 above.

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

- the generation of cash savings at minimum risk;
- the fulfilment of the strategy outlined in section 7 above; and
- the enhancement of the balance of the long-term portfolio (amend the maturity profile and/or the degree of volatility).

8.3 All rescheduling will be subsequently reported to the Cabinet.

9 Delegated Authority

9.1 It is recommended that Cabinet, subject to County Council approval, delegates authority to the Strategic Director of Resources to undertake the activities listed below. These activities will be carried out in accordance with the Treasury Management Practice Documents. Decisions will be made depending on the actual market conditions during the year.

9.2 Borrowing/Funding

- Raising debt finance from the most appropriate of these sources:

    - o Government's Public Works Loans Board
    - o European Investment Bank
    - o Overdraft
    - o Banks and building societies
    - o Local Authorities
    - o Lease finance providers

- Repayment of debt
- Managing the cost of debt
- Delegate authority to treasury management staff to undertake borrowing activities
- Delegated power to include vehicles in the 2006/07 capital programme if borrowing is the preferred financing option, following evaluation of all funding options. Evaluation with regard to the options concerning PWLB borrowing or operating leases will be based on the advice of the Council's leasing consultant.
- Delegated power to approve budget adjustments between departments and the capital financing budget in 'Other Services' to cover borrowing costs.

9.3 CIPFA's *Prudential Code for Capital Finance in Local Authorities* includes the following as a key indicator of prudence:

> "In order to ensure that over the medium term **net 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 capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years."

9.4 Net borrowing refers to the Authority's total external borrowing. The Authority had no difficulty meeting this requirement in 2005/06. Cabinet is asked to approve and recommend to County Council that they request the Strategic Director of Resources to ensure that this requirement is not breached in future years, taking into account current commitments, existing plans, and the proposals in this budget report.

9.5 Investing

- Arranging investments using these instruments:

    - Fixed term deposits with banks and building societies
    - Money Market Funds
    - Local Authorities
    - Government's Debt Management Agency Deposits
    - Bonds & gilts *
    - Certificates of deposit *
    - Treasury Bills*

    *Used by the external cash manager

- Compiling and updating the Lending List, utilising the criteria for counterparties, in consultation with the treasury management consultants. The criteria are fully detailed in the Treasury Management Practice Document, Risk Management.
- Consideration and use of new financial instruments and treasury management techniques
- Managing surplus funds and revenue from investments
- Appointment and performance management of external cash managers
- Delegate authority to invest to designated treasury management staff.

9.6 Use of the Provision for Credit Liabilities (amounts set aside as a provision to meet credit liabilities)

- Use of the PCL balance as the Strategic Director of Resources sees as appropriate

9.7 Loan rescheduling

- Any rescheduling will be done in consultation with the treasury management consultants

9.8 Leasing

- Take out finance leases (recorded on the balance sheet)
- Take out operating leases (revenue expenditure)

Leasing activities are undertaken in consultation with the leasing adviser.

9.9 Policy Documentation

- The formulation and review of the Treasury Management Policy Statement
- The formulation and review of the Treasury Management Practice Documents as follows:
    - risk management (includes credit criteria for the Authority's lending list)
    - best value and performance measurement
    - decision making and analysis
    - approved instruments, methods and techniques
    - organisation, clarity and segregation of responsibilities, and dealing arrangements
    - reporting requirements and management information arrangements
    - budgeting, accounting and audit arrangements
    - cash and cash flow management
    - money laundering
    - staff training and qualifications
    - use of external service providers
    - corporate governance

Neither of the above documents requires Council approval but they are available for viewing.

9.10 Strategy Implementation

- Implementing the Strategy ensuring no breaches of regulations
- Reporting to Cabinet any material divergence from the Strategy
- Making requests to Council to approve amendments to the Strategy as required
- Ensuring that treasury management activities are carried out in accordance with CIPFA Codes of Practice.

10 Annual Investment Strategy

Investment Policy

10.1 The County 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.

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

10.3 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.

10.4 Investment instruments identified for use in the financial year are listed below under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's TMPs.

Specified Investments

All such investments will be sterling denominated (£), with maturities up to maximum of one year, meeting the minimum 'high' rating criteria where applicable.

	*** Minimum 'High' Credit Criteria**	**Use**
Debt Management Agency Deposit Facility	--	In-house
Term deposits – Local Authorities	--	In-house
Term deposits – Banks and Building Societies	Short-term F1, Long-term A, Individual B, Support 3	In-house and External Manager
Certificates of deposits issued by banks and building societies	Short-term F1, Long-term A, Individual B, Support 3	External Manager
Money Market Funds	AAA	In-house and External Manager
UK Government Gilts	AAA	External Manager
Gilt Funds and Bond Funds	Long-term A	External Manager
Treasury Bills	--	External Manager

Non-Specified Investments

	*** Minimum Credit Criteria**	**Use**
Term deposits – banks and building societies (with maturities in excess of 1 year)	Short-term F1, Long-term A, Individual B, Support 3	External Manager
Certificates of deposits issued by banks and building societies	Short-term F1, Long-term A, Individual B, Support 3	External Manager
UK Government Gilts with maturities in excess of 1 year	AAA	External Manager

10.5 The Council's external fund manager will comply with the Annual Investment Strategy. The agreement between the County Council and the fund manager additionally stipulate guidelines and duration and other limits in order to contain and control risk.

10.6 The County Council uses Fitch (one of the main credit rating suppliers) ratings to derive its criteria. All credit ratings will be monitored monthly. The County Council is alerted to changes in Fitch ratings through its use of the Sector Creditworthiness Service. If a downgrade results in the counterparty no longer meeting the County Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

10.7 The County Council's in-house managed funds are mainly cashflow derived and therefore short term. Externally managed funds are derived mainly from reserves and balances and are invested for a longer time period.

10.8 At the end of the financial year, the County Council will report on its investment activity as part of its annual Treasury Management Outturn Report.

DAVID CLARKE
Strategic Director of Resources
Shire Hall
Warwick
January 2006

Appendix A

In year Monitoring 2005-2006

PRUDENTIAL INDICATOR **(1). AFFORDABILITY PRUDENTIAL INDICATORS**	**2005/06** As per TM Strategy **£'000**	**2005/06** Updated for Capital programme agreed 8 Feb Council **£'000**	Quarter 1	Variance to Budget (8 Feb)	Quarter 2	Variance to Budget (8 Feb)	Quarter 3	Variance to Budget (8 Feb)	Reasons for large variances
	£'000	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	
Capital Expenditure	87,729	95,735	95735	0	95,735	0	78,786	16,949	Revised capital programme January 2006
	%	**%**	**%**	**%**	**%**	**%**	**%**	**%**	
Ratio of financing costs to net revenue stream	3.83	3.88	3.58	-0.30	3.58	-0.30	3.59	0.29	
Net borrowing requirement	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	
brought forward 1 April	207,391	207,391	207351	-40	207,351	-40	207,851	-460	Revised borrowing figures
carried forward 31 March	231,305	234,950	229249	-5701	230,808	-4,142	239,398	-4,448	
in year borrowing requirement	23,913	27,559	21897	-5662	23,456	-4,103	31,547	-3,988	
	£'000	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	
In year Capital Financing Requirement	23,913	27,559	27730	171	27,730	171	21,547	6,012	Revised borrowing figure
	£'000	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	
Capital Financing Requirement as at 31 March	226,202	229,798	221245	-8553	221,245	-8,553	215,061	14,737	Adjustment made for final CFR position 31/3/2005 Revised borrowing figure
Affordable Borrowing Limit									
Updated position of Current Capital Programme (Jan 05)	£	£	£	£	£	£	£	£	
Increase per council tax payer	9.48								
Position as agreed at February 2005 Council		11.81	11.74	-0.07	11.76	-0.05	12.20	-0.39	
Increase per council tax payer									

PRUDENTIAL INDICATOR **(2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS**	**2005/06** **estimate** **£'000**	**2005/06** **estimate** **£'000**	Quarter 1 **£'000**	Variance to Budget (8 Feb) **£'000**	Quarter 2 **£'000**	Variance to Budget (8 Feb) **£'000**	Quarter 3		Reasons for large variances
Authorised limit for external debt -									
Borrowing	277,704	282,079	275,237	-6,842	277,108	-4,971	267,482	14,597	Adjustment made for final borrowing figure in 2004/05
other long term liabilities	18,000	18,000	18,000	0	18,000	0	18,000	0	
TOTAL	**295,704**	**300,079**	**293,237**	**-6,842**	**295,108**	**-4,971**	**285,482**	**14,597**	Revised borrowing figure
Operational boundary for external debt -									
Borrowing	231,420	235,066	229,364	-5,702	230,923	-4,143	222,902	12,164	Adjustment made for final borrowing figure in 2004/05
other long term liabilities	15,000	15,000	15,000	0	15,000	0	15,000	**0**	
TOTAL	**246,420**	**250,066**	**244,364**	**-5,702**	**245,923**	**-4,143**	**237,902**	12,164	Revised borrowing figure
Upper limit for fixed interest rate exposure									
Net principal re fixed rate borrowing / investments	100%	100%	100%	0.00	100%	0.00	100%	0.00	
Upper limit for variable rate exposure									
Net principal re variable rate borrowing / investments OR:-	25%	25%	0%	-25%	0%	-25%	0%	0.25	no borrowing taken at variable rate
Upper limit for total principal sums invested for over 364 days	£	£	£		£				
(per maturity date)	0	0	0.00	0.00	0.00	0.00	0.00	0.00	

Maturity structure of new fixed rate borrowing during 2005/06	Upper Limit	lower limit							
under 12 months	20%	0%							
12 months and within 24 months	20%	0%							
24 months and within 5 years	60%	0%							
5 years and within 10 years	100%	0%							
10 years and above	100%	0%	100%		100%		100%		