

BABERGH DISTRICT COUNCIL

FROM: Head of Finance

REPORT NUMBER **E289**

TO: STRATEGY COMMITTEE

DATE OF MEETING 9 March 2006

TREASURY MANAGEMENT STRATEGY AND REVIEW

1. **SUMMARY**

The Council's Treasury Management strategy for the financial year 2006/07 is set out.

2. **RECOMMENDATIONS**

- 2.1 That the Treasury Management Strategy for 2006/07, including the annual investment strategy, as set out in Appendix 2, be approved.
- 2.2 That the Council's current credit ratings criteria, as set out in Appendix 3, continue to apply, with one minor change incorporated to align ratings for UK banks & building societies.

The Committee is able to resolve these matters.

3. **FINANCIAL IMPLICATIONS**

- 3.1 The income generated from the investment of surplus funds is a significant element of the council's budget. At the time of writing this report, it looks likely that around £400,000 of investment income will be generated during 2005/06, which is considerably more than allowed for in the original budget due to much higher levels of surplus funds than anticipated.
- 3.2 These levels of income may not be achieved in 2006/07, though officers will continue to maximise the income generated, within the remit of this strategy.
- 3.3 Borrowing costs have been minimised by borrowing at very low rates in 2005/06.

4. **KEY INFORMATION**

- 4.1 The Treasury Management Strategy operates within the framework of the Prudential capital finance system that came into effect in April 2004.
- 4.2 At this committee's last meeting, prudential indicators under the Prudential Code for Capital Finance were approved. These covered certain aspects relating to treasury management; namely borrowing limits for the next 3 years and limits on exposure to fixed and variable interest rates, should the council need to borrow.
- 4.3 Interest rates have reduced slightly during the last year with most commentators suggesting there will be little movement in the immediate future, though with some debate as to the timing and direction of the next change.

- 4.4 Planned borrowing of £1.1m in relation to the Housing Revenue Account (HRA) for 2005/06 and 2006/07, which is fully supported by Government subsidy, was undertaken in January 2006. The timing was planned to take advantage of the very low interest rates available from the Public Works Loan Board (PWLB). A loan at an interest rate of 3.7% over 50 years was taken.
- 4.5 Some external borrowing in relation to the General Fund is currently expected to be required in 2006/07 in respect of the Customer Access and Service Transformation (CAST) project. We will take advice on the optimum time to undertake this borrowing.
- 4.6 Since becoming debt-free at the end of 2002/03, the level of surplus funds available for investment has remained relatively low. As a result, most investments have been, and are likely to continue to be, short-term although the opportunity to undertake longer-term deposits with higher interest rates could be possible.
- 4.7 Key aspects of the Council's treasury management operations, including the strategy for 2006/07 are explained in the supporting appendices. Factors affecting the strategy are set out in Appendix 1 and the proposed strategy for 2006/07 is set out in Appendix 2. Final activity and performance in 2005/06 will be reported to members after the end of the financial year.

5. **APPENDICES**

- (1) Factors affecting Treasury Management Strategy
- (2) Treasury Management Strategy 2006/07
- (3) Credit ratings criteria for investments

6. **BACKGROUND PAPERS REFERRED TO:**

None.

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Factors affecting the Treasury Management Strategy

Interest Rates

1. This time last year, we reported to members that our expectations for interest rates were for a stable environment, with little movement in the base rate expected. This has indeed been the case, with one reduction – from 4.75% to 4.5% in August 2005 – occurring during the year.
2. The outlook for the immediate future remains stable, though some movement in base rates seems likely. There is, however, some debate as to the timing and direction of the next change. Inflationary pressures such as increasing fuel prices, along with consumer spending and general domestic growth are all factors that can influence interest rate decisions and forecasts for these will always be subject to some doubt.
3. Given the outlook for interest rates, and the level of surplus funds likely to be available for investment, the Council's strategy for the year will continue to focus on investing funds on a low-risk basis, with due regard to cash flow requirements and the yields available.

Investments

4. As reported previously, the Government had issued its 'Guidance on Local Government Investments' under the Local Government Act 2003. The guidance emphasised that priority be given to security and liquidity, rather than yield. However, that does not mean that authorities should ignore yield. It will be reasonable to seek the highest rate of interest consistent with the proper levels of security and liquidity. This has always been this Council's approach, in line with the CIPFA Code of Practice on Treasury Management.
5. The repaying of loans to become debt-free in 2003 has inevitably meant that levels of surplus funds for investment have been lower than would otherwise have been the case. As at the date of preparing this report, the authority had £9.5million invested, with 6 different institutions holding these investments: Skipton Building Society, Bristol and West, Portman Building Society, Abbey, Principality Building Society and Dexia Banque Internationale. This compares with £7.2m reported at this time last year.
6. A pattern has emerged since becoming debt-free, that the average level of surplus funds has gradually increased though it should be noted that the £9.5m includes the £1.1m borrowed in January 2006 as the expenditure has not yet been incurred. This £1.1m is underpinned by a clear borrowing requirement and is purely a temporary component of our surplus funds.
7. Detailed cash flow projections are maintained by officers taking into account all factors affecting the amount of surplus funds potentially available for investment. This means that working capital requirements can be ascertained with a reasonable degree of certainty.
8. This approach will continue to be applied in determining the amounts available for investment and the periods of time for which investments can be made. This will continue to achieve the priorities of security and liquidity, whilst due consideration will be given to achieving the best possible yield.

9. Last year it had been established that a 'core' level of surplus funds exists throughout the year and that it would be possible to consider longer-term investments in order to achieve higher returns. Based on advice from our treasury management advisors, opportunities arose during 2005/06 to invest for 364 days. A deposit of £1m was made at a very attractive rate of 5.17% in March 2005 and a deposit of £0.7m, placed in August gaining a lower rate of 4.44%. Overall, seizing these opportunities has been beneficial and similar discussions will take place with our advisors during 2006/07.
10. Anticipated levels of investment during 2006/07 are likely to follow similar patterns to the current year, with maximum levels in the region of £10 – 12 million, but with periods of time when surplus funds are considerably lower than this.

Borrowing

11. Under the Prudential Code, there is a requirement to set a Prudential Indicator for an authorised limit for external debt. This limit has been set at £6m for 2006/07, increasing to £7.5m in 2007/08 and £10.5m in 2008/09. Additionally, there is an 'operational boundary' below this – this has been set at £3m for 2006/07, £4.25m for 2007/08 and £7.5m for 2008/09. Details were set out in paper E274 as part of the budget setting process for 2006/07.
12. The limits noted above reflect the borrowing requirements of just over £0.5m p.a. for HRA capital expenditure and what might be required for a new Hadleigh swimming pool in 2008/09, along with anticipated borrowing for CAST and other aspects of the General Fund capital programme.
13. The authorised limit for borrowing is consistent with current commitments, existing plans and the proposals in the budget report for capital expenditure and financing. The Prudential Indicators for each year reflect the current outlook for borrowing and are set as limits rather than actual borrowing levels. Actual borrowing levels are likely to be lower than these authorised limits.

Best Practice and CPA/Use of Resources Assessment

14. We have previously reported that we have adopted CIPFA's Code of Practice for Treasury Management in Local Authorities. This, along with three other key guidelines incorporated in our financial regulations, meets the key requirements recommended by the Code as the cornerstones of effective treasury management. In addition to this, the authority has already adopted the 12 treasury management practices also recommended by the Code.
15. We were awarded the maximum score in the CPA ratings for our treasury management activities and are currently awaiting feedback on the Use of Resources Assessment. Initial indications have been pleasing, with the authority's Treasury Management Strategy highlighted as a key area of strength.

Treasury Management Strategy for 2006/07

Use of External Fund Managers

1. The issue of whether to outsource the Council's fund management function has previously been considered and rejected by Members. On the basis that the level of surplus funds for investment remains at a level where the benefits of using an external fund manager are minimal, it is proposed that this is not considered for 2006/07.

Investment of Surplus Funds

2. The Council invests its surplus funds with money market institutions in accordance with an agreed policy. In view of the outlook for interest rates during the year ahead, we will continue to try to maximise investment income, whilst applying the specific priorities of security and liquidity. Most investments will be of less than a year, with the likelihood that the majority of these will be for periods of up to 3 months.
3. We will invest for longer periods depending on prevailing interest rates and the availability of 'core' surplus funds.

Specified and Non-Specified Investments

4. It is proposed that our guidelines for using 'specified' investments remain unchanged from the current approach agreed by members. Specified investments are sterling investments for periods of one year or less and are typically made with the UK Government, a local authority or a body that has been awarded a high credit rating by a credit rating agency.
5. For the forthcoming year, the authority will continue to use the Debt Management Account Deposit Facility, administered by the UK Debt Management Office.
6. Our requirements for credit ratings meet the Government's criteria for ensuring investments are made with institutions with high credit ratings. A minor change is proposed for this strategy, in that the "support" rating for credit-rated Building Societies is to be aligned with that of UK banks. This is reflected in table 1 in Appendix 3. Maximum amounts that may be invested at any time during the financial year with one institution should continue at £3m and we will continue to apply a credit-rating based approach to the maximum period for individual investments. Both short-term and long-term rating criteria are analysed, with one set of minimum acceptable ratings for UK Banks and credit-rated Building Societies and another for Foreign Banks. Further details are set out in Appendix 3.
7. This is determined on the basis of advice from our treasury management consultants and using ratings published by key credit ratings companies, most notably Fitch Ratings Ltd. These are formally reported to us on a monthly basis, with interim notification sent to us if any institution no longer meets our minimum rating criteria. In this event, no further investments would be placed with such an institution, until such time as our criteria are met.
8. Similarly, we propose to maintain our existing arrangements for 'non-specified' investments. These are investments that do not meet the definition set out in para 4, above, and can relate to investments for more than one year, or with institutions without a credit rating (such as many of the UK Building Societies).

9. Advice will continue to be taken from our treasury management consultants in this regard and the authority will always apply the dual considerations of security and liquidity when considering any potential investments. It is proposed that the following be included as acceptable non-specified investments. The first two are as per previous years and ‘callable deposits’ are included for the first time. In addition, to provide absolute clarity on longer-term investments, Bank/Building Society deposits over one year are also included:

➤ Forward dated deals

These are money market cash deposits with approved financial institutions, arranged in advance of making the investment, with a fixed rate of interest at the date of arranging the deal. A commitment is entered into to invest a specified sum in advance, with the interest rate and period determined at the time of entering into the agreement. This means the Council can be assured of receiving a certain level of interest for future investments. The upper limit for these will remain at £1m at any one time.

➤ Building Societies (general investment)

Many Building Societies do not have a credit rating, but are deemed to be highly creditworthy by virtue of the size of their asset base. It is proposed that UK Building Societies with a minimum level of total assets of £2.5 billion be maintained as part of our investment criteria (asset levels as determined in the most recently available published accounts of that institution). We will continue to operate a maximum limit of 70% of the council’s overall investments being with those Building Societies that do not have a credit rating.

➤ Banks & Building Societies (investment over one year)

In order to take advantage of beneficial rates of interest on offer for committing to invest money for longer periods, we should continue to consider investments over one year, provided the usual credit rating or asset base criteria are met.

➤ Callable deposits

These are deposits made with approved financial institutions at a fixed rate where that institution only has the right to repay the loan on set dates. If uncalled, the deposit will run at the agreed rate until the next call date and could run until maturity.

Deposits are likely to be ‘called’ (i.e. repaid to the investor) if market interest rates fall offering the borrower the opportunity to fund themselves more cheaply elsewhere. If rates rise, the deposit is unlikely to be called as this funding could be cheaper than other sources.

These deposits can be made for periods of 3 to 5 years, and pay a higher rate of return than a straight deposit as there is uncertainty for the lender over whether its funds will be returned prior to maturity. There is an inherent interest rate risk attached to these deposits as the authority could miss out on rising rates or face having funds returned in a falling rate scenario. Clearly, we would always seek advice from our Treasury Management consultants should it be felt that such instruments should be considered during the year. The proposed upper limit for these is set at £1m at any one time.

10. We have previously included Euro Sterling Bonds and Money Market Funds in our list of non-specified investments. It is deemed highly unlikely that we would seek to invest in such instruments in the foreseeable future and these will remain off our investment list.

Liquidity of Investments

11. As mentioned earlier in the report, liquidity requirements are determined by detailed cash flow projections. Currently, the prime consideration in this respect is that of working capital needs and

it is not anticipated that this approach will differ in the forthcoming financial year. Similarly, this will determine the amounts and the periods that may prudently be invested at any point in time.

Treasury Management Consultants

12. The Council's contract for treasury management advice was offered for tender in 2005 and ultimately renewed with Sterling Consultancy Services from 1 April 2005 for a period of 3 years. The new contract made provision for reviews on a yearly basis if deemed necessary, due to the need to retain flexibility for support services within the authority. At this point in time, however, there is no reason to review the contract and we are happy to retain the services of Sterling.

Credit Ratings criteria for investments

- The following are the minimum ratings criteria (published by Fitch Ratings Ltd) for any investments made by the Council. These apply to all investments (other than certain Building Societies without a credit rating, where slightly different arrangements apply, as noted in para 9 of Appendix 2).

<u>Institution</u>	<u>Primary</u>		<u>Secondary</u>	
	Short-term	Long-term	Individual	Support
UK Banks & Building Societies	F1	A	B	4
Foreign Banks	F1+	AA-	B/C	2

It is felt appropriate to align the “support” rating for UK Banks & Building Societies and the support rating of 4 reflects a minor change from the previous rating of 3 applied to credit-rated UK Building Societies.

- In terms of maximum period for individual investments, the following will apply:

Credit Level	Credit ratings	Period
1	Highest eg F1+, AA-(minimum), strong secondary criteria	Over 6 months
2	As above, but with slightly lower secondary criteria. Includes other local authorities	6 months
3	Slightly lower primary or secondary criteria	3 months

<u>Explanation - Primary</u>
<p>F1: <i>Highest credit quality.</i> Indicates the strongest capacity for timely payment of financial commitments. Addition of a ‘+’ denotes any exceptionally strong credit feature.</p> <p>A: <i>High credit quality.</i> Denotes low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.</p> <p>AA: <i>Very high credit quality.</i> Denotes a very low expectation of credit risk. Strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.</p>

<u>Explanation - Secondary</u>
<p>“Individual” – these ratings assess how an institution would be viewed if it were entirely independent and could not rely on external support. They are designed to assess a bank’s exposure to and management of risk.</p> <p>“Support” – Support ratings do not assess the credit quality of an institution. Rather, they communicate (Fitch Rating’s) judgement on whether an institution would receive support should it become necessary.</p> <p>Individual:</p> <p>B: <i>A strong institution.</i> There are no major concerns. Characteristics may include strong profitability and balance sheet integrity.</p> <p>C: <i>An adequate institution,</i> which, however, possesses one or more troublesome aspects. There may be concerns regarding its profitability and balance sheet integrity, management, operating environment or prospects.</p> <p>Support:</p> <p>2: A bank for which (in the opinion of Fitch Ratings) state support would be forthcoming, even in the absence of a legal guarantee.</p> <p>4: A bank for which support from a state or from an institutional owner is likely but not certain.</p>

3. Primary criteria are those that an institution must meet. No investments would be placed with an institution falling short of any of the primary criteria. Secondary criteria are not as critical but are still important but are used to fine-tune our overall criteria. They provide additional indications about the security of an institution. Should any institution's rating fall below these secondary criteria (or indeed, not actually have one of the secondary criteria), investments would only be made with the specific approval of the Head of Finance and Performance and based on advice from our Treasury Consultants.
4. Also relevant to the Council's investment decisions are "sector limits". These simply determine the maximum proportion of total investment that may be placed in a particular category at any one point in time. The following is a more explicit demonstration of these limits:

Investment category	Investment type	Upper limit
Specified investments	Deposit with UK bank or building society with high credit rating	100%
	Deposit with foreign bank	70%
Non-specified investments	Deposit with UK building society without a credit rating (less than one year)	70%
	Deposit over one year with approved bank or building society	25%
	Forward Dated deals	£1m
	Callable deposit	£1m
Overall limit for non-specified investments to be 70%		

22 February 2006