

BABERGH DISTRICT COUNCIL

FROM: Head of Finance

REPORT NUMBER **F201**

TO: STRATEGY COMMITTEE

DATE OF MEETING 8 March 2007

TREASURY MANAGEMENT STRATEGY 2007/08

1. **PURPOSE OF REPORT**

To present the proposed strategy for treasury management activity for the financial year 2007/08 and to provide an update on activities in 2006/07.

2. **RECOMMENDATIONS**

- 2.1 That the Treasury Management Strategy for 2007/08, including the key elements of the annual investment strategy, as set out in the attached appendices, be approved.

The Committee is able to resolve the matter.

3. **FINANCIAL IMPLICATIONS**

- 3.1 The income generated from the investment of surplus funds is an important element of the council's budget and is likely to amount to around £440,000 in the current year. The proposed strategy for 2007/08 looks to maximise returns whilst ensuring maximum security and liquidity.
- 3.2 Borrowing requirements and costs in 2007/08 will be carefully monitored and will be minimised by borrowing at the most appropriate time of the year, based on advice from our Treasury Consultants.

4. **RISK MANAGEMENT**

The following risks are associated with this strategy:

Risk Description	Likelihood	Seriousness or Impact	Mitigation Measures
Loss of investment(s)	Almost impossible	<u>Critical</u>	Strict lending criteria to only highly credit rated institutions
Poor return on investments	<u>Low</u>	<u>Marginal</u>	Only deal in cash deposits. Some risk to returns associated with length of investment and Forward Dated deals
Liquidity problems	<u>Almost impossible</u>	<u>Marginal</u>	Cashflow monitoring to ensure this does not arise
Higher than expected borrowing costs	<u>Very low</u>	<u>Marginal</u>	Benchmark is to borrow from the Public Works Loan Board whose rates are very low on a fixed basis

5. **KEY INFORMATION**

- 5.1 The Treasury Management Strategy is agreed annually by this Committee and this operates within the framework of the Prudential capital finance system that came into effect in April 2004.
- 5.2 The Council has approved the prudential indicators under the Prudential Code for Capital Finance as part of the budget agreed on the 26 February. These cover key aspects of our treasury management operations, namely borrowing limits for the next 3 years and limits on exposure to fixed and variable interest rates, should the council need to borrow.
- 5.3 This report does not repeat that detail and the Treasury Management Strategy is, effectively, a tool for delivering the council's Corporate priorities, service plans and Financial Strategy. Members do not, therefore, need to revisit any of the issues considered as part of the Budget setting process.
- 5.4 There have been increases in interest rates during the last year. This trend may continue in the short term with expectations for some possible reduction towards the end of 2007/08. This would suggest that any borrowing should be undertaken later in the next financial year.
- 5.5 There have been no changes to planned borrowing in relation to the Housing Revenue Account (HRA) for 2006/07 and 2007/08 since our report last year.
- 5.6 In relation to the General Fund, it is intended that borrowing will take place in 2007/08 in respect of the Customer Access and Service Transformation (CAST) project, as agreed in the budget and reported previously. Borrowing for the LAMP project is also planned. We will take advice on the optimum time to undertake this borrowing and over what period.
- 5.7 We are always aiming to optimise the income generated by investment of surplus funds. With a relatively low level of surplus funds available for investment, a short-term investment strategy has remained the council's preferred option. However, the opportunity to undertake longer-term deposits with higher interest rates will be investigated. In addition, we plan to examine the benefits of using external cash managers to enhance returns.
- 5.8 Key aspects of the Council's treasury management operations, including the strategy for 2007/08 are explained in the supporting appendices. Factors affecting the strategy are set out in Appendix 1 and the proposed strategy for 2007/08 is set out in Appendix 2. This largely continues the strategy adopted in the current year (as previously reported and detailed in Appendix 2 to Paper E289).
- 5.9 Actual activity and performance in 2006/07 will be reported to members after the end of the financial year.

6. **APPENDICES**

- (1) Key Factors and Information on Treasury Management Activities
- (2) Treasury Management Strategy 2007/08

6. **BACKGROUND PAPERS REFERRED TO:**

None.

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Key Factors and Information on Treasury Management Activities

Factors affecting the Strategy

1. Interest Rates

- 1.1 The Monetary Policy Committee (MPC) surprised the markets for the second time in the financial year with an increase to 5.25% in January. Expectations had been for a rise to 5.25% in February with a possible further rise to 5.50% by the end of the first half of 2007. The market overreacted initially by pricing in 5.75% as the peak, but this is currently being priced out on the back of weaker inflation data and the latest Bank of England quarterly forecasts.
- 1.2 The outlook for the UK economy appears strong suggesting a reasonably firm short-term outlook. There are currently two issues facing the MPC, to control over-target inflation and to reduce the impact of wage settlements on medium-term. It is anticipated that lower inflations and energy bills should see the base rates at 5.25% by December 2007. There is an upside risk to this forecast and that is the behaviour of the UK consumer resulting on greater demand for spending and the subsequent raising prices. If this situation begins to unfold the Bank will display no hesitation in raising rates again.
- 1.3 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.

2. Investments

- 2.1 The Government's guidance on Local Government Investments under the Local Government Act 2003 emphasises 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.
- 2.2 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.
- 2.3 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.

3. Borrowing

- 3.1 The Council intends to undertake borrowing during 2007/08 and this will be done to take advantage of the long-term PWLB rates, which remain at low levels in comparison to short-term investment rates. This will help to keep the costs of financing capital expenditure as low as possible.
- 3.2 The Prudential Code states that that if a financial strategy is to be prudent (i.e. not borrowing to fund revenue expenditure or to invest), it is one in which in the medium term net borrowing is only to be used for capital purposes.

Information on Treasury Management Activities

4. Surplus Funds

- 4.1 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 has £8.9m invested (around the same level as at the same time a year ago), with 6 different institutions holding these investments: Skipton BS, Bristol and West, Portman BS, Abbey, Northern Rock BS and the Bank of Scotland.
- 4.2 A year ago, we committed £1m of our “core” surplus funds in a Forward Dated one-year investment to achieve prospective higher returns (following the advice of our Treasury management advisors). This was at the fixed rate of 4.86%, which is now likely to return slightly less than other possible short-term rates during 2007/08.
- 4.3 We will be engaging with our advisors to review our investment options for 2007/08 - maximum levels of surplus funds are expected to be in the range of £12-14m next year. The outcomes will be reported to Members as part of future annual reports.

5. Borrowing

- 6.1 The Council’s net external borrowing does not exceed the total Capital Financing Requirement and therefore we are in a position to borrow if deemed necessary.
- 6.2 The Council has an asset base of £220m and can borrow to maintain that and provide new or improved facilities, subject to affordability.
- 6.3 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 £7m for 2007/08, increasing to £11m in 2008/09 and £14.5m in 2009/10. Additionally, there is an ‘operational boundary’ below this – this has been set at £4m for 2007/08, £8m for 2008/9 and £11.5m for 2009/10. Details were set out and attached to paper F191 as part of the budget setting process for 2007/08.
- 5.4 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 maximum limits rather than actual borrowing levels. Actual borrowing levels are likely to be lower than these authorised limits, especially in relation to any new Hadleigh Pool.

Treasury Management Strategy for 2007/08

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. We will be revisiting this matter again in 2007/08 and will be seeking further advice based on existing surplus funds levels.

Investment of Surplus Funds

2. This Council has regard to Government guidance as cited under Section 15(1)(a) of the Local Government Act 2003 and CIPFA's Code of Practice on Treasury Management in the Public Services.
3. The Secretary of State recommends that each Local Authority produces an Annual Investment Strategy, approved by full Council, that sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.
4. This Investment Strategy states which instruments the Council may use for investment purposes, making a distinction between Specified and Non-Specified Investments.
5. This strategy also determines limits in respect of the overall level of non-specified investments and within that limit, an upper limit to be held in each category of non-specified investment.
6. The prime objective of the Council's investment strategy is to ensure prudent investment of surplus funds. The Council's investment priorities are the security of capital, liquidity of investments and within those objectives, to secure optimum performance.
7. 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.

Specified Investments

8. An investment is a specified investment if:
 - a. The investment is denominated in Sterling and all payments or repayments are payable only in sterling
 - b. The investment is not a long-term investment (i.e. due to be repaid within 12 months of the date in which it was made or one which the Council may require to be repaid within that period)
 - c. The making of the investment is not defined as capital expenditure by virtue of regulation 25(1)(d) of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 [SI 3146 as amended]; and
 - d. The investment is made with a body which has been awarded a high credit rating, or is made with any of the following:
 - i. The United Kingdom Government
 - ii. A Local Authority in England and Wales, or a similar body in Scotland or Northern Ireland

iii. A Parish or Community Council

9. The following categories of investments will be used under the definition of Specified Investments:
- a. Money Market Funds
 - b. Debt Management Agency Deposit Facility
 - c. Short Term cash deposits with highly credit rated institutions
 - d. Callable cash deposits with highly credit rated institutions
 - e. Reserve Account
 - f. Forward deals (provided the maturity date is < 1 year from when the investment was made)
 - g. UK Government Bonds (with maturity dates of < 1 year)
 - h. Certificates of Deposit (with maturity dates of <1 year)
10. For the purposes of 9 d) above, the Council considers a high credit rating for Money Market Funds (9 a) above to be those with a long term Fitch Rating of AAA (or the equivalent highest rating from Standard and Poors or Moodys)
11. For the purposes of 9d) above, the Council considers a high credit rating for categories 9 c) and 9 d) above to be as follows:

Fitch Credit Rating	Minimum Level to be considered high	
	UK Banks & Building Societies	Foreign Banks
Short Term Rating	F1	F1+
Long Term Rating	A	AA-
Support Rating	4	2
Individual Rating	B	B/C

12. The Council will monitor these ratings on a regular basis based on information received from their treasury advisers. A monthly full update of the list will be received and any rating changes in the interim will be notified as and when they occur.
13. In terms of maximum period for individual investments, the following will apply:

Credit Level	Credit ratings	Period
1	Highest e.g. 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

Non-Specified Investments

14. Any investment that does not meet all of the criteria for Specified Investments is deemed to be a Non-Specified Investment.

15. Non-specified Investments, therefore relate to non-credit rated institutions or investments made for periods greater than 1 year, which are considered less liquid as the cash is not quickly realisable. Provided precise procedures determine the processes to be undertaken in assessing suitable institutions for non-specified investments, they should not be considered less secure than specified investments.
16. It is clear from the Government guidance that the intention is not to discourage the use of Non-Specified Investments, but to make sure that they are properly considered and that there are appropriate procedures in place for risk management.
17. In practice, this would mean that investments within the Building Society sector and longer term investments will be the only non-specified investments that the Council is likely to utilise. In all other respects the same rating and limit criteria, set out in TMP 1, will apply.
18. The Council is required to set a limit, expressed as either a sum of money or as a percentage of total investments. This can range from 0 to 100%. The limit for unspecified investments as a percentage of total investments is 70%.
19. The following instruments will be used by the Council and the following limits, as a proportion of the total investments, will be placed on each category of investment:

Instrument	Limit
Deposits with non-rated Building Societies	70%
Term Deposits (maturity date > 1 year)	25%
Callable Deposits (maturity date > 1 year)	£1m
Forward Deals (maturity > 1 year)	£1m

20. It should be noted that the credit ratings specified above also apply to non-specified investments (those investments over one year).

Liquidity of Investments

21. The Secretary of State recommends that the Investment Strategy sets out the procedures for determining the maximum periods for which funds may be prudently committed.
22. The level of funds to be committed for periods in excess of 1 year will be determined based on cash flow forecasts and the identification of core-cash. At a more detailed level, the appropriate period of investing will be based on on-going advice from the Council's treasury advisers.

Treasury Management Consultants

23. The Council's treasury management advisors are Sterling Consultancy Services whose current contract began in April 2005 and will be due for renewal in April 2008. This 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 in 2007/08.

25 February 2007