

BABERGH DISTRICT COUNCIL

FROM: Head of Finance

REPORT NUMBER **G215**

TO: **STRATEGY COMMITTEE**

DATE OF MEETING **6 March 2008**

TREASURY MANAGEMENT STRATEGY 2008/09

1. PURPOSE OF REPORT

To present the proposed strategy for treasury management activity for the financial year 2008/09 and to provide an update on activities in 2007/08.

2. RECOMMENDATIONS

- 2.1 That the Treasury Management Strategy for 2008/09 , including the key elements of the annual investment strategy, as set out in the attached appendices, be approved.

The Committee is able to resolve this 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 £650,000 in the current year. The proposed strategy for 2008/09 looks to maximise returns whilst ensuring maximum security and liquidity.

- 3.2 Borrowing requirements and costs in 2008/09 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

- 4.1 This report is most closely linked with Significant Business Risk No. 7 – Financial, Performance & Risk Management. The following risks are associated with this strategy:

Risk Description	Likelihood	Seriousness or Impact	Mitigation Measures
Loss of investment(s)	Almost impossible	Critical	Strict lending criteria to only highly credit rated institutions
Poor return on investments	Low	Marginal	Only deal in cash deposits. Some risk to returns associated with length of investment and Forward Dated deals
Liquidity problems	Almost impossible	Marginal	Cashflow monitoring to ensure this does not arise

Risk Description	Likelihood	Seriousness or Impact	Mitigation Measures
Higher than expected borrowing costs	Very low	Marginal	Benchmark is to borrow from the Public Works Loan Board whose rates are very low and can be 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 prudential indicators under the Prudential Code for Capital Finance as part of the budget agreed on the 22 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 Interest rates have been volatile during the year with rates peaking at 5.75% in July 2007. There have, however, been two decreases in recent months and the base rate has now returned to the same level as at the start of the year. For the year as a whole, this has resulted in more investment income during 2007/08 than originally anticipated, which has been helpful.
- 5.4 During 2007/08, we looked at using external cash managers and pooling surplus funds with other Councils to enhance returns. The case for taking such an approach was not compelling but we will continue to monitor the position during 2008/09.
- 5.5 There have been no changes to planned borrowing in relation to the Housing Revenue Account (HRA) capital programme for 2007/08 and 2008/09 of £550,000 in each year since our report last year.
- 5.6 In relation to the General Fund capital programme, a small borrowing need may arise in 2007/08. A much more substantial potential borrowing need in 2008/09 of up to £2.5m is indicated in the capital programme. We will take advice on the optimum time to undertake this borrowing and over what period.
- 5.7 Key aspects of the Council's treasury management operations, including the strategy for 2008/09 are explained in the supporting appendices. Factors affecting the strategy are set out in Appendix 1 and the proposed strategy for 2008/09 is set out in Appendix 2. This largely continues the strategy adopted in the current year.
- 5.8 The aim of the strategy is to optimise the income generated by investment of surplus funds whilst ensuring maximum security. 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 taken should this be seen as beneficial and appropriate.

- 5.9 Attention is drawn to Section 23 of Appendix 2 and the contract for external treasury management consultants. Given the current situation, it is felt that opportunities for joint working on this should be explored. To enable that to happen, it is proposed that the existing contract be extended by up to 6 months.
- 5.10 Actual activity and performance in 2007/08 will be reported to members after the end of the financial year.
- 5.11 The contract for external treasury advisors expires on the 31 March 2008. An extension to the current contract, by up to 6 months, to enable opportunities for joint working to be explored is being sought.

6. **APPENDICES**

- (1) Key Factors and Information on Treasury Management Activities
- (2) Treasury Management Strategy 2008/09

7. **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 After a strong period of economic output since 2005, the credit squeeze and cooling in growth abroad has diminished the outlook for the UK economy over the next year. From a position in August 2007, when the MPC signalled that another rate hike to 6% was needed to control inflation in an economy running at near capacity, the credit squeeze has led to significant downside risks to growth. The resulting problems in financial markets are at risk of spreading into the real economy as wary lenders restrict credit, restrictions that will affect business investment and personal consumption.
- 1.2 The Bank of England expects a sharp reduction in the rate of growth in 2008 and has cut Bank Rate to 5.25% since December in an effort to reduce the downside risks to inflation in the medium-term. However, the task before policymakers has been complicated by rising inflationary pressure from food and oil prices, which is expected to raise the possibility of the CPI rate exceeding 3% during 2008. The Bank has acknowledged that it can do little to arrest this spike, but in order to control expectations a more controlled and limited reduction in Bank Rate is more likely than an extensive series of rate cuts. From the current level of 5.25%, a measured reduction throughout 2008 to 4.5% is probable. From there the rate may remain steady for 6-12 months.
- 1.3 There are both upside and downside risks to this forecast. The upside risk is that UK economic growth does not slow as expected, which may increase the pressure on inflation and reduce the magnitude of monetary loosening. The downside risk is that the outlook for growth deteriorates and the Bank will have to cut more extensively to meet the medium term inflation target.

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.
- 3.1 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. Surplus Funds

- 3.1 As at the date of preparing this report, the authority has £10.3m invested (£1.4m higher than at this time last year), with 6 different institutions holding these investments: Bank of Ireland, West Bromwich BS, Bradford & Bingley, Britannia BS, Abbey and Principality BS.
- 3.2 Investment options for 2008/09 will be considered with our external advisors - maximum levels of surplus funds are expected to be in the range of £13-15m next year but will obviously be lower than this at certain times during the year.

4. Borrowing

- 4.1 The Council intends to undertake significant borrowing during 2008/09 in relation to the capital programme and this will be done to take advantage of the best possible long-term PWLB rates, providing they 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.
- 4.2 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.

Treasury Management Strategy for 2008/09

Use of External Fund Managers

1. The issue of whether to use external Fund Managers is marginal given the relatively low level of core surplus funds for investment. However, we will continue to monitor this during 2008/09 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 sited 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(s)
 - f. Forward deals (provided the maturity date is < 1 year from when the investment was made)
 - g. Certificates of Deposit (with maturity dates of <1 year)
 - h. UK Government Bonds (with maturity dates of < 1 year)
10. For the purposes of the above, the Council considers a high credit rating for Money Market Funds (9a) 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 9 c to g above, the Council considers a high credit rating for these 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.
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

Credit Level	Credit ratings	Period
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.
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-credit 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.

Borrowing

23. As the Council's net external borrowing does not exceed the total Capital Financing Requirement, we are in a position to borrow if deemed necessary.
24. The Council has an asset base of £220m and can borrow to maintain that and provide new or improved facilities, subject to affordability.
25. 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 £9.5m for 2008/09 , (increasing to £11m in 2009/10 and £12m in 2010/11). Additionally, there is an 'operational boundary' below this – this has been set at £6.5m for 2008/09 (£8m for 2009/10 and £9m for 2010/11). Details were set out and attached to paper G204 as part of the budget setting process for 2008/09.
26. The authorised limits 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.

Treasury Management Consultants

27. The Council's treasury management advisors are Sterling Consultancy Services whose current contract will be due for renewal in April 2008. It may, however, be appropriate to extend this pending further consideration of joint working opportunities.

25 February 2008