DERBY CITY COUNCIL

COUNCIL CABINET
22 FEBRUARY 2005

ITEM 16

Report of the Director of Finance

Treasury Management Strategy and Prudential Code Indicators 2005/6

PROPOSED ACTION

1.1 To recommend Council to approve the planned prudential indicators set out in Appendix 2 and summarised in Appendix 4.

1.2 To recommend Council to adopt the Treasury Management Strategy for 2005/6, including the Annual Investment Strategy, as set out in Appendix 3 to this report.

1.3 To recommend Council to authorise the Director of Finance to determine whether to agree to the transfer to the Council of net external loans from Derbyshire County Council relating to assets transferred to the Council upon Local Government Reorganisation in 1997.

SUPPORTING INFORMATION

2.1 The Local Government Act 2003 removed from April 2004 the general requirement for Government approval to be given to local authority borrowing, and also removed the accompanying complex system of regulations that governed such decisions. Instead, Councils must now adopt annually the prudential indicators set out in the Prudential Code for Capital Finance in Local Authorities, as determined by the Chartered Institute of Public Finance and Accountancy – CIPFA. This is given statutory force by regulations under the Act.

2.2 In addition, the Council must approve a Treasury Management Strategy, which also incorporates the Annual Investment Strategy required under the regulations introduced with the Local Government Act 2003.

Prudential Indicators and the Treasury Management Strategy

2.3 Several of the prudential indicators are determined within the Treasury Management Strategy, and it therefore makes sense to consider both within the same report. The prudential indicators are also dependent upon the scale of the Council's capital programme for 2005/6 to 2007/8, as contained in a separate report on this agenda.

2.4 The overriding objective of the Prudential Code is to make sure that the capital investment plans of local authorities are affordable, prudent and sustainable. This is intended to be delivered through the adoption of the prudential indicators. It remains for the Council to set the indicators itself, subject only to the controls of Section 4 of the Act, which allow the Government to intervene in exceptional circumstances to set national, or individual limits for Councils. These powers have not to date been invoked by Government. It is expected that they will continue to remain latent so long as local authorities demonstrate that they continue to behave prudently when taking borrowing and investment decisions.

2.5 The most important of the indicators, in terms of constraining capital investment decisions, are those relating to affordability. The affordability indicators set out the extent to which the revenue budget is funding the capital cost of borrowing and also the marginal impact of capital expenditure decisions on future levels of council taxes and rents. The latter indicators depend in particular on the extent to which the Council undertakes 'unsupported borrowing', additional to that supported by grant funding from Government. The proposed indicators are set at a prudent level which incorporates a proposed continued supplement of £2m a year of unsupported borrowing to enhance the capital programme, although it is envisaged that this may be revised upwards in 2005/6 to permit self-financing 'spend to save' unsupported borrowing. Each £1m of unsupported borrowing costs around £25,000 to finance in the first year and £90,000 in a full year. This amounts to a long term supplement of £1.30 per annum to the Band D council tax.

2.6 Most of the proposed prudential indicators are explained in detail in Appendix 2 to this report. The exceptions are those prudential indicators which relate to treasury management. These are referred to in Appendix 2 and explained in detail in paragraphs 3.5 and 4.9 of Appendix 3. Appendix 4 provides a summary of all of the prudential indicators.

2.7 The Treasury Management Strategy proposed for 2005/6 is generally consistent with the approach taken in previous years.

2.8 The only significant exceptions in Appendices 2 and 3 to the approach proposed in previous years are the following:

- It is proposed that the prudential indicator that constrains the absolute level of borrowing by the Council – the Absolute Limit - should reduce from 25% to 15% above the level of the Capital Financing Requirement as the current limit provides excessive headroom over the CFR. This is explained further in section 2 of Appendix 2.

- Our treasury advisers are currently evaluating, jointly with Derbyshire County Council, whether the City Council should take over the debt relating to its assets that were previously part of the County Council prior to Local Government Reorganisation. This debt is still managed by the County Council and costs are recharged to the City Council. Details are explained further below. It should however be noted that the prudential indicators that differentiate between external and internally managed debt will need to change accordingly if the transfer goes ahead. These are referred to in section 3 of Appendix 2.

- Building Society investments are currently limited to 60% of the total investment portfolio, compared to an upper limit of 70% for banks. This limit is causing some difficulty when placing funds. Our Treasury advisers are suggesting that this be reviewed to a consistent level of 70% for each sector, as there is no material increase in risk with a top 20 building society compared to banks, whilst there are marginally better returns available. It is therefore proposed in Appendix 3 that this limit be revised to 70%. It is also proposed that this change should take place for 2004/05 with immediate effect following Council approval on 2 March as it is a current issue.

- The borrowing strategy to be adopted is slightly different to that adopted for 2004/5. Our Treasury advisers consider that it would be prudent to delay the bulk of borrowing until the latter part of 2005/6, when long-term interest rates are expected to have fallen back from higher levels in the early part of the year. If necessary, external borrowing in 2005/6 may also be quite limited, as there is a case for reducing the Council's external investments as an alternative source of funds. The strategy however recognises that borrowing and investment decisions will be dependent on market conditions generally, and operational decisions on timing of borrowing need to be flexibly applied.

2.9 The Treasury Management Strategy also sets out details of investment and borrowing performance over the past year. Investment performance has been particularly good, with returns over the year to date that have averaged 4.89% over the year to date and have consistently outperformed both Bank of England Base Rate and money market rates. The Council has also continued to take advantage of lower long term borrowing rates. The Council's debt held with the PWLB is now held at an average rate of 5.34% compared to a rate of 6.3% assumed by the Government to be typical of local authorities. This good performance is reflected in the Treasury Management revenue budget estimates for 2005/6, which are included within the proposals put forward for adoption by Cabinet.

Local Government Reorganisation Debt Managed by Derbyshire County Council

2.10 In April 1997, following Local Government Reorganisation, the Council took into its accounts approximately £58m of net external long term liabilities relating to the debt outstanding in respect of the assets transferred to the Council from Derbyshire County Council. Since then, the County Council has managed the debt on Derby's behalf, recharging the annual principal and interest cost to the Council, plus a small management fee. The County Council debt, excluding 'other district' debts, currently stands at a gross amount of £46.9m, but net of loans owed to the City Council, the total is £42.3m.

2.11 The technicalities of the former capital control regime prevented the Council from considering any option to redeem or transfer the loans in the interests of efficiency or value for money. However, since the introduction of the Local Government Act 2003, the constraints have changed. The Council's external treasury advisers have therefore been asked to evaluate the option of the Council managing the external loans directly.

2.12 Our advisers' initial view is that there would be material financial benefits if the Council were to take over most of this debt. The benefits arise primarily from the fact that the County's average interest rate for existing external loans is currently higher than the City Council's. Direct management of the debt would allow some of the difference in the interest rate to be funded from HRA subsidy, at no net cost to the HRA. At present, the General Fund funds all of the higher interest rate debt, so the cost to the General Fund would reduce.

2.13 The County Council are being consulted on the proposals and are expected to agree, subject to cost neutrality on their part. Our advisers, who also advise the County, are now undertaking detailed preparations for the transfer. Subject to Council approval on 2 March including the authorisation of the Director of Finance to give final approval, and similar formal authorisation by the County Council, then if the final advice of our advisers confirms the availability of material savings, the transfer would be take place as soon as practicable, and if possible by 31 March 2005.

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Background papers:	None
List of appendices:	Appendix 1 - Implications Appendix 2 - Prudential Indicators Appendix 3 - Treasury Management Strategy 2005/06 Appendix 4 - Prudential Indicator Summary 2005/06

IMPLICATIONS

Financial

1. As detailed in the report

Legal

2. The Council is obliged to set and review prudential indicators in order to comply with the Local Government Act 2003. Unless the Government uses its powers under Section 4 of that act, the Council is free to set any reasonable indicators consistent with its other policies.

Personnel

3. None

Equalities impact

4. None

Corporate objectives and priorities for change

5. The objectives of the Council's Treasury Management Strategy contribute to minimising Council Tax and providing Value for Money

APPENDIX 2

Prudential Indicators 2005/06

The required indicators have been grouped as follows:
1. Plans for capital expenditure
2. Borrowing Limits
3. Prudence
4. Affordability
5. Treasury Management

The proposed figures are then summarised at the end of this appendix.

They have to be set with regard to the following matters:
- Affordability – for example the effect on the Council Tax
- Prudence and sustainability – for example the implications for external borrowing of the plans
- Value for money – for example through option appraisal
- Stewardship of assets – for example through asset management planning
- Service objectives – for example through strategic planning processes
- Practicality – for example the achievability of the forward plan.

1. Plans for Capital Expenditure

The plans for capital expenditure need to be consistent with the Council's capital programme for 2005/6 to 2007/8, which the Council will approve on 2 March. The figures included in this report are based on the recommendations to the Cabinet, in a separate report on this agenda on the capital programme for 2005/06 to 2007/08. The first indicator is the plan for Capital expenditure for the next three years:

	General Fund (GF)	HRA	Total
	£m	£m	£m
2005/6	37.6	32.3	69.8
2006/7	32.2	8.0	40.1
2007/8	26.5	8.1	34.5

Actual capital expenditure for 2004/5 will be recorded and reported after the end of the financial year. The actual capital expenditure for 2003/4, as reported to cabinet in November 2004 was £75.7m, of which, £36.8m related to the GF, and £38.9m to the HRA. The substantial reduction in the HRA element from 2006/07 is due to the planned completion of the Homes Pride programme. The figures exclude the outline plans for the HRA to finance an 'estates sustainability fund' of £3m a year from HRA revenue sources, subject to sufficient finance continuing to be available. Such spending may include both revenue and capital items, and therefore final plans for HRA capital spending in 2006/07 and 2007/08 may increase by any amount up to £3m should the plans be finally agreed next year. The actual planned amount will be included in next year's report.

2. Borrowing

Capital Financing Requirement, or CFR

The CFR uses balance sheet figures to indicate the maximum amount of capital financing that should be required by the Council to finance its assets, on the best information available at the time of setting the capital programme. This increases as more resources are spent on creating or enhancing capital assets, and reduces as debt is repaid, or capital grants, revenue or usable capital receipts are applied to finance capital expenditure. Technically, the CFR is the sum of the following items on the balance sheet:

- Fixed Assets
- Deferred Charges
- Fixed Asset Restatement Account
- Capital Financing Account
- Government Grants Deferred.

In addition, any forms of credit arrangements, including finance leases, are included in the total CFR.

	General Fund	HRA	Total
CFR at the end of:	£m	£m	£m
2003/4 – actual	145.4	127.2	272.6
2004/5	158.7	164.4	323.1
2005/6	174.0	189.0	363.0
2006/7	182.6	189.7	372.4
2007/8	188.5	190.5	379.1

Authorised Limit and Operational Boundary

Section 3 of the 2003 Local Government Act imposes a duty on the Council to set a limit on how much money it can afford to borrow and to keep this under review. The 'Authorised Limit' is an absolute limit on borrowing, and may not be exceeded. Additionally, the Council must set an 'operational boundary' for borrowing. This is a level of borrowing that, if exceeded frequently, indicates a potential problem with the borrowing strategy. These targets are required to be set on a 'rolling' three-year basis.

The Government may, under Section 4 of the 2003 Act, impose an overall limit on the borrowing of every local authority 'for national economic reasons', and/or on an individual authority 'for the purpose of ensuring that the authority does not borrow more than it can afford'. Although 2005/06 is only the second year of the new system, it is not anticipated that either provision will be used.

The *Operational Boundary* for borrowing needs to be set higher than the expected level, to avoid reporting every small movement above the expected amount of borrowing. An element of variability in the exact timing of borrowing and spending has to be allowed for. For example, Cabinet on 21 December 2004 determined to bring forward external borrowing for 2005/6 in view of market conditions. Additional borrowing on 'spend to save' schemes is also possible, as are additional government funded permissions to borrow for capital purposes as happened during 2004/05 with additional ALMO funding of £16.1m. These factors are particularly volatile and mean that a sensible level of operational boundary is difficult to set appropriately. If it is set too high it is never used, and if too low would be triggered too often. No specific guidance has been provided, either by the government or by CIPFA on what an appropriate level should be. It is left to individual authorities' judgement. An appropriate level for the operational boundary in 2004/05 was set at 10% above the CFR and it is proposed to maintain the limit at this level, given the volatility described.

The absolute limit, or *Authorised Limit* on borrowing to be set, is also a matter for the Council to decide. For 2004/05, this limit was initially set at 25% above the CFR, providing headroom of approximately £80m. Although a breach of this limit is not permitted by the legislation, it is also considered that a revised limit for 2005/06 of around 15% or approximately £54m above the expected level of borrowing would be more appropriate and require further consideration by Council. It should be noted that the government effectively funds the majority of borrowing, either through capital financing FSS, HRA subsidy or government grant. Any increase in net borrowing from these sources does not put any significant additional pressure on the Council Tax, other than where unsupported borrowing takes place. If further unsupported borrowing were to be proposed, beyond that provided for in the capital programme, this would require further approval.

The limits proposed for approval are set out below:

	Operational Boundary	Authorised Limit
End of financial year:	£m	£m
2005/6	381	417
2006/7	391	428
2007/8	398	436

In addition to this limit, a separate limit is required for other long-term liabilities, for example finance leases or other forms of credit arrangements. It is the intention to minimise new long-term liabilities other than borrowing, and the limit is therefore set to reflect only existing liabilities of this type, or other such liabilities to cater for any exceptional needs

	Operational Boundary	Authorised Limit
End of financial year:	£m	£m
2005/6	1	1
2006/7	1	1
2007/8	1	1

3. Prudence

The Prudential Code requires a statement that the total net external borrowing excluding any transferred debt is less than the Council's CFR. This is to ensure that overall external borrowing exposure is not excessive. The requirement of the code is that external borrowing should not exceed the CFR at the end of the final year (2007/08). In addition to the formal indicator, a further, local indicator has been shown to include debt held and managed by other local authorities, where these remain debts for which the Council is ultimately liable.

The figures for Derby shown below, demonstrate that total net external borrowing will be less than the CFR in 2005/06 and subsequent years. For 2004/05, borrowing temporarily exceeds the indicator as the CFR has been revised downwards following slippage in the capital programme.

Financial year End	External Debt Excl. externally managed debt	External Debt Incl. externally managed debt	CFR
	£m	£m	£m
2003/4	216.7	269.5	272.6
2004/5	285.7	335.0	323.1
2005/6	315.1	362.5	363.0
2006/7	324.5	370.0	372.4
2007/8	331.1	374.9	379.1

It should be noted that consideration is currently being given to the transfer of some externally managed debt into direct management by the Council. If such a transfer takes place, a corresponding adjustment will be made to the formal indicators, consistent with the authority sought from Council to implement the transfer.

4 Affordability

With the new powers afforded under the 2003 Act, there is a considerable reduction in the legal barriers to any increased level of borrowing. This is balanced by a lack of any additional funding for any borrowing that does not fall within the levels approved by the government. This means that all borrowing beyond government limits is no longer illegal, but has to paid for by the authority concerned from within its own funding streams, that is, the council tax or housing rents.

The affordability measures required could therefore be regarded as the most important indicator in judging whether such borrowing is acceptable to the Council.

The indicators in this section relate separately to the GF and HRA. In the case of the HRA, it is proposed, as it was in 2004/05, not to do any unsupported borrowing. The HRA figures therefore relate solely to the funded capital programme. Figures for the GF from 2005/6 include £2m a year of unsupported borrowing to support the corporate capital programme, plus £1.085m of expected slippage from 2004/5. This excludes any additional unsupported borrowing that might subsequently be approved by the Council. At the moment, therefore, the proposed capital spending plans include annual unsupported borrowing as follows:

	Corporate Programme	Approved Spend to Save	Total
	£m	£m	£m
2004/5	1.60	2.75	4.35
2005/6	3.09	2.10	5.19
2006/7	2.00	0.35	2.35
2007/8	2.00	0	2.00

The first affordability indicator is the expected *Ratio of financing costs to the net revenue stream*. This attempts to measure the relative level of debt costs in each authority. As stated earlier, the government will support the vast majority of such debt. Direct comparisons between sectors or authorities are not therefore very meaningful other than to measure the overall level of such debts that are held. The indicators for Derby, based on unsupported borrowing indicated above and a continuation of MRP at the minimum level for corporate programme schemes, and voluntary repayment of debt for spend to save schemes, are:

End of financial year:	GF %	HRA %
2005/6	4.78	22.35
2006/7	4.72	23.27
2007/8	4.53	23.75

The indicators for the current and previous years are as follows:

2003/4 Actual	4.21	23.60
2004/5 Estimated	4.03	19.11

The second affordability indicator is an estimate of the incremental *Impact of capital investment decisions on the Council Tax.* This is defined in the Prudential Code as the incremental impact of the difference between the total budgetary requirement of the Council with no changes to the existing capital programme and the total budgetary requirement of the Council with the additional programme. This can be interpreted in several ways, but our external auditors have accepted the Council's treatment. That is that the real financing cost to the Council relates solely to the cost of unsupported borrowing, and it is this that is therefore the difference between the existing and proposed capital programmes. The measure below is therefore based on the planned £2m a year of unsupported borrowing that is added to the corporate capital programme, and that both funded capital schemes – from any existing source, for instance government approvals, capital grants or revenue contributions. 'Spend to Save' schemes are excluded from the calculation as their approval is dependent on realisation of equivalent savings. The Council also considers that the other net revenue costs of schemes are zero in total. This is on the basis that the additional running costs of some schemes are offset by savings on the extra costs of maintenance funded by direct revenue contributions that would otherwise have to be incurred.

On the basis that the new assets will be paid for over 25 years, and using an interest rate of 5%, the impact of additional unsupported borrowing is as follows:

	2004/5 £m	2005/6 £m	2006/7 £m	2007/8 £m
Total new prudential borrowing	4.35	5.19	2.35	2.00
Less 'Spend to Save' schemes	2.75	2.10	0.35	0
Total new prudential borrowing to support Corporate Programme	1.60	3.09	2.00	2.00
Cumulative average spent mid year	0.80	3.27	5.93	7.93
Repayments of principal (4%) – A	0.00	0.06	0.19	0.27
Outstanding balance	1.60	4.87	6.68	8.41
Interest at 5% on average spent - B	0.05	0.16	0.30	0.40
Other net revenue running costs – C	0.00	0.00	0.00	0.00
Total revenue cost (A+B+C)	0.05	0.22	0.49	0.67

Impact on Council Tax (Band D / year)

The first year has a lesser impact as the spending takes place part way through the year. Therefore, while the immediate impact of the first £1.60m is only 75p a year, the full year impact will be £2.69 a year on Band D property. Should further unsupported borrowing be approved, this would impact on the Council Tax at around £1.35 a year on Band D for each £1m of new borrowing.

The incremental impact of capital investment decisions on housing rents is zero, as there is no unsupported borrowing affecting the HRA.

The other indicators are based on estimated average interest rates for the Council's total borrowing of 5.25%. This average is low compared to the average of many authorities, indicated by government funding for interest costs in FSS being based on 6.3% interest rates for 2005/6. Such rates reflect the average of all loans outstanding, not just the costs of new loans taken at current interest rates.

In summary, the proportion of the Council’s spending on debt is rising, but it remains at affordable levels as the vast majority of capital spending is funded through government grant or revenue support.

5. Treasury Management

The prudential indicators required for Treasury Management relate to the balance of borrowing and investments between fixed and variable interest rates, and the maturity profile of borrowing. These are intended to spread risks between types of borrowing and investment, between types of interest charged, and across borrowing periods. The following indicators are proposed for 2005/06:

The formal indicator required by the code relates to the *net exposure to interest rates*. As in 2004/05, this has been supplemented by local indicators for borrowing and lending separately in order to aid clarity. The required indicator is:

	Upper Limit % of principal	Lower Limit % of principal
Fixed rate	100	80
Variable rate	20	-20

The figures of 120% to –20% are to cater for a situation where the Council has no variable rate borrowing but holds some variable rate investments. The local indicators are:

	Upper Limit % of principal	Lower Limit % of principal
Long term borrowing:		
Fixed rate	100	80
Variable rate	20	0
- Lending		
Fixed rate	100	30
Variable rate	70	0

All these indicators are unchanged from the current financial year.

Overall Maturity Structure of Long Term borrowing:

	Upper Limit %	Lower Limit %
Under a year	15	0
> 1 year and < 2 years	15	0
> 2 years and < 5 years	30	0
> 5 years and <10 years	50	0
> 10 years	100	50

Short-term borrowing has been excluded from the above figures

These indicators indicate that the plan in 2005/06, as in previous years, is to spread the balance of the future maturity of loans as far as possible. This is discussed more fully in the Treasury Management Strategy.

The Prudential Code also requires a planned limit on investments made over one year in length. It is suggested that this limit should continue to be £25m, to be applicable to loans maturing between 1 and 3 years from the date of investment. No investments will be made for a period of more than 3 years. As the Treasury Management Strategy makes clear, no such investment will be undertaken without the express consent of the Director of Finance.

APPENDIX 3

Treasury Management Strategy 2005/06

Including Annual Investment Strategy

1. SUMMARY

1.1 The Council is required to adopt a Treasury Management Strategy under the CIPFA Code of Practice for Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities.

1.2 The Council's plans are to finance a capital programme of £69.8m using up to £44.17m of borrowing during 2005/06, aiming to borrow this amount at the most advantageous interest rates available during the year. £9.5m of this has already been financed from advanced borrowing during 2004/05 to take advantage of low interest rates of 4.50% in late December 2004. If interest rates are unfavourable in the short term, but there is a prospect of lower rates later, the option may be taken to run down cash balances available for investment rather than borrowing the full amount. The precise market position will be taken into account to determine this, in consultation with our advisers.

1.3 The Council will also review debt-restructuring opportunities in pursuit of cost savings, in relation both to County Council managed debt and PWLB debt.

1.4 The 2003 Act requires local authorities, as part of an annual investment strategy, to identify limits for specified and non-specified investments based on an assessment of risk minimisation, return on investments, required liquidity and expenditure commitments. It is suggested that an appropriate limit for investments beyond a year and for non-specified investments as a whole be set at £25m. While top 20 building societies without a credit reference are formally non-specified investments, it is proposed to exclude these from the £25m limit to make sure that investments continue to make the best returns without any significant increase to risk. There would instead be a lower limit of £3m in any such institution (Annex 2).

1.5 In February 2005, the Bank of England base rate is forecast by our treasury advisers to remain constant for the first half of 2005/06, with a possible reduction of 0.25% for the second half. The general strategy toward investments is to undertake either short or long dated investments that outperform market expectations, informed by our treasury advisers. Market rates will inevitably move during 2005/06, and the Council will react to such changes to optimise performance within the constraints of controlling risks.

1.6 To date, performance on borrowing during 2004/05 has broadly reflected actual market movements. PWLB borrowing has been taken at an average rate of 4.85% against an average 25 year+ PWLB rate of 4.84% and an average 10 year rate of 5.00%. The average return on investments to date of 4.89%, has outperformed the average Bank of England base rate of 4.56% for 2004/05. Such good performance cannot be guaranteed each year, and it would be imprudent to budget on the basis that the Council would continue to outperform the markets.

1.7 It is proposed to increase the maximum proportion of investments allowed to be invested in Building Societies from 60% to 70% in line with the maximum for Banks.

2. BACKGROUND

2.1 Treasury Management is defined in the latest Code of Practice as:

"The management of the organisation's cash flows, its banking, money market and capital market transactions; effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".

2.2 These functions are carried out within a framework set by legislation. Authorities are required, under the provisions of the Local Government Act 2003, to have regard to the CIPFA prudential code for Capital Finance for borrowing and the CIPFA Treasury Management Code for investments and for the wider exercise of treasury functions generally.

2.3 It is a requirement of the CIPFA Treasury Management Code of Practise to produce Treasury Management Practices (TMPs). The Cabinet approved Derby's TMPs in November 2002. A requirement of these approved practices, endorsed by the prudential code, is the production of an annual strategy for the financial year ahead. This report seeks to identify the Council's treasury management plans for the financial year 2005/06, which have been produced in consultation with its external treasury consultants.

3. BORROWING STRATEGY

3.1 In determining Derby's borrowing strategy for 2005/06, account has been taken of:

- the latest regulatory framework
- the existing borrowing structure
- potential borrowing requirement for the year, including ALMO loans
- sources of new borrowing
- external factors influencing borrowing decisions, for example interest rate movement.

3.2 Regulatory Framework

The following key factors influence the Council's borrowing strategy:

- the Treasury Management Code of Practice issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) which took effect from April 2002

- the Local Government Act 2003, introducing the Prudential Code

- the Council's Treasury Management Practices

- the Council's planned borrowing limit, described as its Capital Financing Requirement (CFR), and determined in accordance with the Prudential Code.

3.3 Existing Borrowing Structure

As at 31 March 2005, it is expected that the Council will have external debt amounting to £334.9m against an expected capital financing requirement for the same date of £336.7m. This consists primarily of loans from the Public Works Loan Board (£262.9m) at a weighted average interest rate of 5.34% together with market loans of £22.7m taken as Lenders option, Borrowers option (LOBO) loans, plus net debt transferred from the County Council in 1997 of £49.3m. All PWLB loans are currently at fixed rates, with the LOBO loans running at a very low (0.75%) rate until June 2005, increasing to the higher rate of 4.45% or the prevailing market rate thereafter. As prevailing PWLB rates have moved upwards since the LOBO loans have been taken, the Council will have gained significantly from this arrangement. However, in recent weeks, rates have fallen to similar levels available when the LOBO's were taken, and on balance, our advisers feel that the lenders option to request an increase in the rate of 4.45% may not be exercised next year.

2004/05 borrowings, including the £9.5m taken in advance of 2005/06 are expected to total £60.0m, having been taken at a weighted average rate of 4.85%. This has broadly reflected actual market movements, the average 25 year+ and 10-15 year PWLB rates having averaged 4.84% and 5.00% respectively.

3.4 Debt managed by Derbyshire County Council

The Council is currently evaluating with the County Council, the merits of ending the arrangement whereby the County continues to manage debt relating to the City's assets transferred on Local Government Re-organisation. This review is with a view to making financial savings for the City Council at no cost to the County Council. The current arrangements result in a significant proportion of the City Council's debt being charged directly against the General Fund rather than shared with the Housing Revenue Account. If agreement can be reached with the County Council to transfer a fair selection of their existing debts to the City Council this would allow cost neutrality for them, but result in a slightly higher income for the HRA to fund the increased overall interest rate. This would allow the general fund to make a saving without any loss for either the HRA or the County Council. This option is therefore being pursued with the County Council, who have indicated that they are content with our approach as long as their overall costs are not increased.

The outstanding debts between the Council will stand on 1st April 2005 as follows, showing the approximate interest rate payable on each portion:

	£m	%
Debt owed by City to County – gross	46.94	6.2
Less debt owed by County to City for 1974 assets	(6.17)	5.0
Add City portion of 1974 debts returned in 1997	1.55	5.0
Net debt owed by City Council to County	42.32	

These debts exclude any debt held by the County on behalf of third party districts. All these debts will be considered carefully before any final decision is taken.

Prudential Indicators for Treasury Management

3.5 The prudential code requires the formalisation of an indicator detailing net exposure to interest rates, which is borrowing net of investments. It is proposed to retain the indicator as set for 2004/05, as follows:

	Upper Limit % of principal	Lower Limit % of principal
Fixed rate	120	80
Variable rate	20	-20

The figures of 120% and –20% are to cater for a situation where the Council had no variable rate borrowing, but held some variable rate investments.

To aid clarity, the official indicator is supplemented with separate local indicators for long-term borrowing. This local indicator is shown below:

	Upper Limit % of principal	Lower Limit % of principal
Long term borrowing:		
Fixed rate	100	80
Variable rate	20	0

This indicator states that no more than 20% of long-term borrowing can be taken at variable rates. For clarity, LOBO loans are regarded as variable.

Additionally, we are required to state, in compliance with the prudential code, the planned maturity structure for long-term borrowing. The following, which follows guidance in the code and existing best practice principles, was approved by Cabinet during 2004/05, and is proposed for 2005/06:

	Upper Limit %	Lower Limit %
Under 1 year	15	0
> 1 year and < 2 years	15	0
> 2 years and < 5 years	30	0
> 5 years and < 10 years	50	0
> 10 years	100	50

This structure will ensure a smooth loan maturity profile is maintained, thus reducing the Council's exposure to high interest rates when refinancing. It also allows for sufficient flexibility to aloe for loans to be taken to take advantage of subsequent restructuring opportunities.

3.6 2005/06 Borrowing Requirement

The further maximum amount the authority expects to borrow to fund planned and previous capital expenditure in 2005/06 is currently £24.3m. This has been calculated as follows:

	£m
2004/05 borrowing not taken	-
New borrowing using central government Supported Capital Expenditure (SCE)R allocations for 2005/06 (including £23.8m SCA funding for ALMO expenditure)	38.98
Unsupported Borrowing	5.19
Long Term loan repayments 2005/06	0.12
Potential borrowing requirement 2005/06	44.29
Of which, relates to previous years capital financing	5.60
Less: earmarked for repayment of debt	4.27
Net increase in expected debt (CFR)	34.42
Less: Borrowing in Advance of 2005/06	9.50
Expected Maximum Borrowing 2005/06	24.92

3.7 Sources of Borrowing

The authority can meet its financing requirement by a combination of borrowing from external sources and/or use of funds generated internally.

If the authority chooses to borrow externally, it can use either the money market or the Public Works Loans Board (PWLB). Historically, PWLB loan interest rates have been lower than other forms of long-term borrowing, and the authority has therefore tended to borrow from this source. However, opportunities arose during 2003/04 to borrow from the market at advantageous rates, reflected in the Council's decision to borrow £22.7m in the form of LOBO loans.

From 2004/05, funds created internally have only one primary source. This is the amount the authority must set aside from the revenue account to meet debt repayments, known as the minimum revenue provision, MRP. The timing of the use of these funds is left for the authority to manage. The element of housing capital receipts previously set aside to repay debt is now paid direct to the government in the year it is received.

3.8 Factors influencing borrowing decisions

The Council's treasury management advisers have produced their economic outlook and interest rate forecasts for the next financial year(s). Their observations are discussed below.

Current advice from our advisers is that long dated PWLB debt and some variable rate debt offers the best value for borrowing, and that commitment to medium dated debt should be avoided. PWLB rates are however, expected to rise slightly during 2005/06, but to drop back to current levels towards the end of the financial year. Any substantive reliance on variable debt should also be avoided as it would leave the Council exposed to market fluctuations, and does not therefore minimise risk.

With the exception of LOBO loans, where the Council can limit the extent of variability, variable debt has been avoided, and it is planned to continue this policy. For similar reasons, there is also a need to achieve a debt maturity profile that reduces exposure to market changes in any one year. Recommended limits are that no more than 15% of the debt portfolio should mature in any one year, which limits the use of short dated borrowing.

It is therefore considered appropriate that the Council should continue with its approach of taking mostly long dated fixed rate debt, where borrowing is necessary, with the current preference for long over medium and short dated loans being subject to review if market conditions change.

The need for variable rate debt at this time is questionable. The Council retains significant surplus cash balances, much of which is invested at what are in effect variable rates due to the relatively short period of the investment. The strategy for 2005/06, as in 2004/05, will consider the option of running down cash balances significantly over the year, the extent of which will depend on the value considered to be available from long and medium dated borrowing. In so far as this is an option, it will also provide flexibility over the timing of external borrowing when prevailing market rates are considered to be particularly low.

Any decisions need to take account of the precise market position at the time, and future policy has to be sensitive to the volatility of market sentiment.

Options are available to the Council to reschedule further long-term loans in 2005/06, which may be running at disadvantageous interest rates, or where savings can be made to reduce the debt charge costs to the authority. Derby's external treasury advisors will continue to provide rescheduling forecast models to determine the financial implications of repaying and/or replacing specific loans, which may be acted upon under delegated powers.

The Council may also, under delegated powers, enter into additional or replacement LOBO loans should market conditions appear advantageous. Such loans however, will be treated as being a fixed loan of a duration only relating to the outstanding fixed term of the LOBO, and risks will therefore be limited by the limits on authorized short term borrowing set under the prudential code.

4. ANNUAL INVESTMENT STRATEGY

4.1 The Council, in devising its annual Investment Strategy, must have regard to the guidance on Local Government Investments issued by the Office of the Deputy Prime Minister (ODPM) in March 2004. The guidance, which replaced the approved investment regulations set out in the Local Government and Housing Act 1989, came about as part of the introduction of the new prudential capital finance system. Prudent investment practices are still encouraged, but without the same detailed prescriptive regulation.

This strategy is intended to satisfy the requirements of both the CIPFA Code of Practice on Treasury Management, as in previous years, together with the requirements of the ODPM guidance.

ODPM guidance states that local authorities must identify the types of investment they are to use during a financial year under the headings, *'Specified Investments'* and *'Non-specified investments'*. Specified investments refer to those investments offering higher security. The security of these deposits allows local authorities the freedom to rely on them with minimal or no procedural formalities. Non-specified investments refer to those investments which carry either a higher risk, possibly in a facility with no formal credit rating, but often higher liquidity, or for periods of one year or more.

This strategy sets out:

- the maximum periods for which funds should be committed
- minimum and maximum limits (%) to be invested in each investment type
- which investments will be classified as non-specified
- degree of prior advice to be sought before use of non-specified investments
- any limits on the split of fixed and variable interest rates for investments

4.2 The Council's investment policy in previous years has been to maintain a positive short-term cash flow by using capital receipts and revenue reserves and balances to avoid the need to borrow externally for short-term purposes. It has however, reserved the right to do so should any cash shortages arise on a day-to-day basis. This policy has worked effectively and it is proposed to continue. Base rates, since rising sharply from 4% to 4.75% in the first 5 months of 2004/05, have now stablised. During this period, the Council has secured an average return on external investments 0.34% higher than the average base rate. Our advisers predict that the current base rate of 4.75% is likely to remain stable, likely only to move in the latter half of 2005/06 with a 0.25% reduction to 4.5% expected by the end of 2005/06. It is normal however, for forecasts to change as market conditions change.

4.3 The Council's ability to secure a good rate of return has depended on its ability to act flexibly when market conditions suggest a particular investment is good value. The general strategy is therefore to take either short or long dated investments that outperform market expectations, informed by the view of our treasury advisers..

4.4 Short-term cash available for investment has fluctuated between £63m and £135m so far during 2004/05 and averaged £114m. It has been invested only with institutions on the Council's approved list with restrictions on overall amounts for particular institutions and sectors. It is expected that surpluses in 2005/06 will fall back from these levels, particularly if there is a decision to borrow internally to fund capital expenditure. The borrowing requirement is lower in 2005/06 than 2004/05, reflecting primarily the profile of Homes Pride capital works funded from supported capital borrowing.

4.5 Annex 1 details the Specified Investments lending criteria, including the maximum lending limits and terms for individual counterparties and sectors.

4.6 The ODPM investment guidance introduced for 2004/05, allows for flexibility in which investment facilities can be used. However, the Council's prime concern must still be the security of the authority's funds. When setting a limit for non-specified investments, this, together with the expected level of balances, the need for liquidity, and spending commitments over the next 3 years must be taken into account. Based on these factors, it is recommended to continue with a maximum of £25m of the Council's investment portfolio that can be prudently committed to longer term, higher risk Non-Specified investments, and for a maximum term of 3 years.

4.7 Those investment opportunities which will be classified as Non-Specified Investments under the ODPM guidance are described in Annex 2.

It is necessary to specify in this strategy, those investments which the authority feels comfortable investing in. Based on advice from our treasury consultants, the following criteria should be taken into account in making a decision on those instruments to include in the strategy.

- Certainty of rate of return on investment
- Quality of credit rating
- Certainty of no loss in the capital value of the investment
- Level of Liquidity

In the interests of minimising risk and maximising prudence, it is proposed in this investment strategy to include the following as Non-specified investment counterparties:

- Term deposits over 364 days
- Forward Deposits maturing over 364 days

These facilities are secure and can be subject to stringent credit ratings. They are however, illiquid as deposits must run their term.

Non-Specified Investments with their own official credit rating will be subject to the same lending limits and counterparty restrictions as Specified Investments (Annex 1).

Advice will be sought from the Council's treasury advisers prior to any decision being taken regarding the investment of funds in any Non-Specified Investment. Additionally, no Non-Specified Investment transactions will be carried out without the express consent of the Director of Finance.

4.8 The Authority's lending list for specified and non-specified investments will as usual, be continually reviewed during 2005/06 to make sure that:

- sufficient lending capacity exists to comply with limits set for fixed and variable interest rate investments
- the authority is taking maximum advantage of all investment opportunities
- credit rating changes are accounted for
- liquidity is maintained
- sufficient spread on investment counterparties and financial sectors is maintained

Consideration will also be given to the overall level of investments when applying such limits, to ensure that the reliance on any one institution or financial sector remains in proportion to the overall portfolio. It is proposed, following advice from external advisers, to increase Building Society limits from 60% of the overall portfolio, to 70% as discussed in annex 1.

4.9 The following are the limits that it is proposed to set specifically for the council's lending for 2005/06:

Upper Limit	Lower Limit	
	% of principal	% of principal
Fixed rate	100	30
Variable rate	70	0

This is a local indicator under the Prudential Code and means that at least 30% of the Council's investments must be placed in fixed rate investments.

4.10 When placing money with counterparties, the CIPFA Code of Practice for Treasury Management states that it is best practise to spread investments between brokers and direct dealing counterparties, subject to the rates offered. The Council currently actively uses 6 brokers and 4 direct counterparties for money market deals. It is felt that these are considered sufficient at this time.

SPECIFIED INVESTMENTS

APPROVED ORGANISATIONS FOR INVESTMENT

No overall limit has been placed on the total level of funds placed in specified investments as a proportion of the Council's total investment portfolio, due to the low risk associated with the counterparties within this asset class. In assessing the approved organisations to be included as specified investments, the following criteria have been used:

- the security of the Council's investment with particular reference to:
- the rating of the institution for short-term investment risk (local authorities only lend for up to 364 days for specified investments)
- the rating of the institution as a 'standalone' organisation without reliance from state authorities or its owners;
- the rate of return available;
- having a sufficient spread of institutions to ensure that funds can be invested without difficulty.

Individual Institution Limits

It is proposed, in order to determine a better understanding of an institutions creditworthiness, to continue to base the selection of institutions on the 3 industry approved credit rating services, subscribed to by our treasury management consultants and widely used by many local authorities. They are 'Fitch', 'Moody's', and 'Standard & Poors'.

The minimum criteria required for all institutions are also proposed to continue as follows:

<table>
<tr><td>Short Term</td><td>Long Term</td><td>Individual</td><td>Legal/Support</td><td>Limit</td></tr>
<tr><td>F1+</td><td>AA</td><td>A or B</td><td>3</td><td>£15m</td></tr>
<tr><td>F1</td><td>A</td><td>A or B</td><td>4</td><td>£10m</td></tr>
<tr><td colspan="4">Other top 20 Building Societies, but without a credit rating</td><td>£6m</td></tr>
<tr><td colspan="4">Other subsidiaries of institutions meeting the above criteria, but without their own credit rating</td><td>£3m</td></tr>
</table>

Our treasury advisers state that all of the top 20 building societies can be considered to be particularly low risks, even where they have not sought to secure a formal credit rating. Such building societies will be treated as if they had a credit rating for the purposes of determining whether investments with them count against the £25m applying to non-specified investments.

Sector Limits

2004/05 sector limits, based on the existing criteria above are as follows:

Sector	Sector Limits
	% of portfolio
UK Banks	70% (incl. foreign banks)
UK Building Societies	60%
Foreign Banks	70% (incl. UK banks)

It is proposed to increase the building society sector limit in line with UK and Foreign Banks to 70%, following confirmation from our advisers of the sectors strength, and that the Council is unlikely to be at any additional risk. This will enable the Council to improve its ability to invest in building societies, which tend to pay higher returns.

Note on rating system

Short-term: This relates to the expectation of investment risk and the timely repayment of principal and interest for periods up to 12 months - Top rating F1+

Individual: This assesses the question "if the bank were entirely independent and could not rely on support from state authorities or its owners, how would it be viewed?" - Top rating A, lowest rating E

Long term: This relates to investment risk and the timely payment of financial commitments of 365 days or over - Top rating AAA

Legal/Support: This relates to the support which an institution may receive should it get into financial difficulty. The rating does not indicate the quality of the organisation - Top rating 1, lowest rating 5

Other Facilities

Money Market Funds (max of £20 million or a sector limit of 30%, whichever is the higher)

	Long Term Rating	Limit
Barclays Global	AAA	Up to £15 million
AIM Global	AAA	Up to £15 million
Standard Life Investments	AAA	Up to £15 million
Gartmore	AAA	Up to £15 million
RBS Global Treasury Funds	AAA	Up to £15 million

Debt Management Account (DMA) Facility

Government run facility which, therefore, carries AAA rating and, hence, a maximum investment of £15m

NON-SPECIFIED INVESTMENTS

POTENTIAL INVESTMENT OPTIONS & ASSOCIATED RISK

The maximum limit for non-specified investments at any one time is ***£25m*** and the maximum term is ***3 years***

The following investments are considered to be in keeping with Derby's wider Treasury Management strategy of maintaining effective control of risks whilst pursuing optimum performance consistent with those risks.

Type	Credit rated?	Benefits/Risks
Term deposits over 364 days	Yes	-Certainty of rate of return -No movement in capital Value -Illiquid -Credit risk i.e. if credit rating changes
Forward Deposits	Yes	-Certainty of rate of return -Certainty of capital value -Credit risk i.e. if credit rating changes -Cannot renege on investment -Interest rate risk

The following investments, whilst allowable under the ODPM investment guidance, are not currently considered in keeping with the Council's strategy, and will be kept under review.

Type	Credit rated?	Benefits/Risks
Certificate of Deposit (CD) over 364 days	Yes	-Relatively liquid -Yield subject to movement during life of CD which could negatively impact on value
Callable Deposits over 364 days	Yes	-Enhanced returns compared to term deposits -Illiquid as only borrower has right to repay -Interest Rate risk if rates rise -no control over term of investment
UK Government Gilts	Govt. backed Credit quality	-certainty of return if held to maturity -Very liquid -potential for capital gain/loss -Redeemable within 12 months
Supranational Bonds	AAA or govt. backed	-Relatively liquid -certainty of return if held to maturity -potential for capital gain/loss -Redeemable within 12 months

Other Non-Specified Investments

Investments with Building Societies that do not have an official credit rating are technically classed as non-specified. They are however, in every other way, the same as a specified investment. Such investments have been excluded from the overall £25m limit for non-specified investments, but in order to recognise the absence of a credit rating, the following individual limits will apply:

Top 10 Building Society – no credit rating	£6m
Top 11-20 Building Society – no credit rating	£3m

APPENDIX 4

Prudential Code Indicators Summary 2005/06 - 2007/08

Prudential Code Reference	Indicator	Actual 2003/04	Estimated: 2004/05	2005/06	2006/07	2007/08
Affordability						
35 - 36	**Forecast Financing cost to Net Revenue Stream Ratio**					
	- General Fund %		4.03%	4.78%	4.72%	4.53%
	- HRA %		19.11%	22.35%	23.27%	23.75%
37-38	**Actual Financing cost to Net Revenue Stream Ratio**					
	- General Fund %	4.21%				
	- HRA %	23.60%				
39	**Incremental Impact on Council Tax: Band D £/year**			3.31	7.17	9.68
Local	**Marginal Impact on Council Tax: Band D £/year per £1m each year**			0.37	1.69	2.99
40-41	**Incremental Impact on Housing Rents £/week**			0.00	0.00	0.00
Prudence						
45	**Actual / Forecast Borrowing compared to CFR**					
	- External Debt excluding Transferred Debt £m	216.7	285.7	315.1	324.5	331.1
	- CFR £m	272.6	323.1	363.0	372.4	379.1
Local	- External Debt including Transferred Debt £m		335.0	362.5	370.0	374.9
	- CFR £m		323.1	363.0	372.4	379.1
Capital Expenditure						
51-52	**Total Capital Expenditure**					
	- General Fund £m			37.6	32.2	26.5
	- HRA £m			32.3	8.0	8.1
	- Total £m			69.8	40.1	34.5
53-54	**Estimated Capital Financing Requirement**					
	- General Fund £m		158.7	174.0	182.6	188.5
	- HRA £m		164.4	189.0	189.7	190.5
	- Total £m		323.1	363.0	372.4	379.1
57-58	**Actual Total CFR £m**	272.6				
External Debt						
59	Authorised Limit for borrowing £m			417	428	436
	Authorised Limit for other long term liabilities £m			1	1	1
	Authorised Limit £m			418	429	437
60	Operational Boundary for borrowing £m			381	391	398
	Operational Boundary for other long term liabilities £m			1	1	1
	Operational Boundary £m			382	392	399
Treasury Management						
66	**Adopted CIPFA Treasury Management Code of Practice**	Yes	Yes	Yes	Yes	Yes
67-70	**Interest Rate Exposure - Fixed**					
	Upper limit %			120	120	120
	Lower limit %			80	80	80
67-70	**Interest Rate Exposure - Variable**					
	Upper limit %			20	20	20
	Lower limit %			-20	-20	-20
Local	**Long term Borrowing - Fixed rate**					
	Upper limit %			100	100	100
	Lower limit %			80	80	80
Local	**Long term Borrowing - Variable rate**					
	Upper limit %			20	20	20
	Lower limit %			0	0	0
Local	**Investments - Fixed rate**					
	Upper limit %			100	100	100
	Lower limit %			30	30	30
Local	**Investments - Variable rate**					
	Upper limit %			70	70	70
	Lower limit %			0	0	0
74	**Maturity Structure of Debt - % of all debt**			Upper Limit %		Lower Limit %
	Under a year			15		0
	Between 1 and 2 years			15		0
	Between 2 and 5 years			30		0
	Between 5 and 10 years			50		0
	Over 10 years			100		50
77	**Investments over a year - limit £m** Additionally, no investment to be longer than two years from date of investment			£25m	£25m	£25m