DERBY CITY COUNCIL

COUNCIL CABINET
20 FEBRUARY 2007

Cabinet Member for Corporate Policy

Treasury Management Strategy and Prudential Code Indicators 2007/08

SUMMARY

1.1 Appendix 2 to this report sets out the required Prudential Indicators as required by the Prudential Code for Capital Finance. It demonstrates that the Council's Capital expenditure plans are prudent and affordable.

1.2 The report also sets out in Appendix 3, the proposed Treasury Management and Annual Investment Strategy for 2007/08, taking into account the prudential indicators proposed for future years.

1.3 Appendix 3 identifies that both borrowing and investment decisions taken during 2006/07 to date have had a positive impact on the Council's finances, with investments to date outperforming the average Bank of England base rate.

1.4 Subject to any issues raised at the meeting, I support the following recommendations.

RECOMMENDATION

2.1 To recommend that Council approves the planned prudential indicators set out in Appendix 2 and summarised in Appendix 4.

2.2 To recommend that Council adopts the Treasury Management Strategy for 2007/08, including the Annual Investment Strategy, as set out in Appendix 3 to this report.

REASON FOR RECOMMENDATIONS

3. The CIPFA Code of Practice for Treasury Management requires that all local authorities prepare an Annual Treasury Strategy and plan in advance of a new financial year. The Local Government Act 2003 introduced the prudential capital finance system, which requires the formal adoption of this code of practice and requires in addition, the preparation of an Annual Investment strategy.

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Report of the Corporate Director – Resources and Housing

Treasury Management Strategy and Prudential Code Indicators 2007/08

SUPPORTING INFORMATION

1.1 Since April 2004, Councils must 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 Local Government Act 2003.

1.2 In addition, the Council must also 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

1.3 A number of the required prudential indicators are determined within the Treasury Management Strategy, and therefore both are considered within the same report. The prudential indicators are also dependent upon the scale of the Council's capital programme for 2007/08 to 2009/10, as detailed in a separate report on this agenda.

1.4 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 delivered through the adoption of prudential indicators. The Council sets 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 are expected to remain latent so long as local authorities demonstrate that they continue to act prudently when taking borrowing and investment decisions.

1.5 The most important of the indicators, in terms of constraining capital investment decisions, are those relating to affordability. They 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 ratio of net financing costs to the net revenue stream demonstrates that, while the relative costs of financing general fund debt are rising, it is only a very gradual increase and does not undermine the sustainability and affordability.

1.6 The overall capital programme is still considered to be affordable and prudent. Provision for costs are fully contained within the separate proposals on revenue budgets contained in reports to this Cabinet. The programme incorporates a continued supplement of £2m a year of unsupported borrowing met from the

Treasury Management revenue budget**.** In addition, there are a number of further self-financing capital schemes funded from unsupported borrowing. Some of these are funded from savings that they generate, and others are funded from previously approved service revenue budgets at no additional net cost.

1.7 Most of the proposed prudential indicators are explained in detail at Appendix 2 to this report. The exceptions are those prudential indicators that relate to treasury management, which are also referred to in Appendix 2 and explained in detail in paragraphs 3.5 and 4.9 of the Treasury Management Strategy in Appendix 3. Appendix 4 provides a summary of all of the prudential indicators.

1.8 The Treasury Management Strategy proposed for 2007/08 is consistent with the approach taken in previous years. It sets out details of investment and borrowing performance during 2006/07. Investment performance has compared favourably with the market, with returns over the year to date averaging 5.00%, some 0.25% higher than the average Bank of England Base Rate for 2006/07. The Council has also continued to take advantage of lower long term borrowing rates, including £58.750m rescheduling of debt in 2006/07. The Council's debt is now held at an average rate of 4.92% compared to a rate of 5.9% assumed by the Government to be typical of local authorities for 2007/08.

1.9 This performance is reflected in the Treasury Management budget estimates for 2007/08 to 2009/10, which are included within the proposals put forward for adoption by Cabinet. The budget position is being tightened considerably over the next three years, and there is now a considerable reliance on income from investment balances held by the Council.

1.10 The major change in Treasury Management over the last couple of years has been a shift in government funding for capital from supported revenue funding to direct grants. This has meant that there is now less of a need to borrow than in previous years, and this has been reflected in lower overall borrowing costs within the Treasury budget.

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Background papers:	The Prudential Code for Capital Finance in Local Authorities, CIPFA
List of appendices:	Appendix 1 - Implications Appendix 2 - Prudential Indicators Appendix 3 - Treasury Management Strategy 2007/08 Appendix 4 - Prudential Indicator Summary 2007/08

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 2007/08

The required indicators are grouped as follows:

1. Plans for capital expenditure
2. Borrowing Limits
3. Prudence
4. Affordability
5. Treasury Management

They have to be set with regard to the following:

- 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.

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

1. Plans for Capital Expenditure

The plans for capital expenditure must be consistent with the Council's capital programme for 2007/08 to 2009/10, which the Council will approve on 1st March. The figures included in this report are based on the recommendations to the Cabinet Pre-Agenda meeting. A separate report on the capital programme for 2007/08 to 2009/10 is included on this Cabinet agenda, and following the Cabinet meeting the Treasury Management Strategy report will be updated and reported to Council.

The first indicator is the plan for Capital expenditure for the next three years:

	General Fund (GF)	HRA	Total
	£m	£m	£m
2007/08	99.1	10.7	109.8
2008/09	48.8	10.6	59.4
2009/10	34.9	11.7	46.6

Actual capital expenditure for 2006/07 will be recorded and reported after the end of the financial year. Latest estimates are total spend of £83.4m, of which £73.1m relates the GF and £10.3m to the HRA. The actual capital expenditure for 2005/06, as reported to Cabinet in August 2006 was £76.4, of which, £45.3m related to the GF, and £31.1m to the HRA.

2. Borrowing

Capital Financing Requirement - 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
2005/06 (actual)	134.0	188.5	322.5
2006/07	151.0	189.5	340.5
2007/08	175.0	190.5	365.5
2008/09	177.2	191.5	368.7
2009/10	178.8	192.5	371.3

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'. It is not anticipated that either of these provisions will be used in the near future. Should this happen, however, there would be a marked change in the ability of the Council to borrow further prudential funds. The slight risk of this outcome is one reason for continuing to borrow further funding each year as the programme develops rather than reducing cash balances.

Our treasury management advisors have recently advised us that the *operational boundary* for borrowing need only be set at the expected CFR for each year, after transferred debt – managed by the County Council on our behalf – has been removed. As the City Council aims not to borrow above the CFR this seems to be a sensible level. Previously the *operational boundary* was set at 10% above a CFR calculation that included transferred debt.

The *authorised limit* on borrowing is also a matter for the Council to decide. For 2004/05, this limit was set at 25% above the CFR (with transferred debt included), providing headroom of approximately £80m. In later years it was considered that a lower limit of 15% would be more appropriate and this has proved sufficient. However, there are a number of developments, relating to a potential Waste Disposal investment, the Council's accommodation strategy and other prudential borrowing proposals, that, whilst not yet formally part of the capital programme, might be added to the capital programme over the next few years. These would, if agreed, add substantially to the amount of borrowing required. It is therefore suggested that the Authorised Limit be increased to 20% above the CFR (excluding transferred debt) to reflect these possible developments. This will provide headroom of approximately £70m. The operational boundary will be increased at the time that a major proposal is adopted.

The revised limits proposed for 2007/08 for approval are set out below:

Borrowing	Operational Boundary	Authorised Limit
End of financial year:	£m	£m
2007/08	366	439
2008/09	369	443
2009/10	372	446

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.

Other long-term liabilities	Operational Boundary	Authorised Limit
End of financial year:	£m	£m
2007/08	1	1
2008/09	1	1
2009/10	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 third year being reported (2009/10).

The figures for Derby shown below demonstrate that total net external borrowing will be approximately equal to the CFR in 2007/08 and subsequent years in the absence of advanced borrowing:

	External Debt	CFR
	£m	£m
2005/06 (actual)	328.5	322.5
2006/07	340.2	340.5
2007/08	365.3	365.5
2008/09	368.5	368.7
2009/10	371.2	371.3

4 Affordability

The affordability measures required can be regarded as the most important indicators to be used for judging whether borrowing is prudential.

Since the additional powers afforded under the 2003 Act, there has been a considerable reduction in the legal barriers to any increased level of borrowing. This has been 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 borrowing beyond government limits is not illegal, but has to be paid for by the Council from council tax or housing rents.

Since April 2006, only a small portion of the marginal cost of financing ‘supported’ capital expenditure has been funded from Formula Grant. This is due to the operation of the system of ‘floors’ within the grant system. Only 31% of the marginal revenue cost of capital expenditure has been funded by Formula Grant in 2007/08. The changes to the affordability indicators, to show a revised calculation of the marginal cost of the capital programme, are explained later in the report. Capital expenditure within approved limits on HRA services continues to be fully funded from subsidy.

The current proposed capital spending plans include borrowing-funded schemes as follows:

	Supported Borrowing SCE(R)	Unsupported Borrowing (Corporate)	Unsupported Borrowing (Service Financed)	Unsupported Borrowing (Spend to Save)	Total Borrowing
	£m	£m	£m	£m	£m
2006/07	15.7	4.3	2.6	1.4	24.0
2007/08	10.1	19.6	3.5	0.4	33.6
2008/09	9.4	2.2	0.6	0.1	12.3
2009/10	9.4	2.1	0.0	0.0	11.5

The first affordability indicator is the expected **ratio of financing costs to the net revenue stream.** This attempts to measure the relative level of total debt costs in each authority. The indicator is unaffected by the changes in Government support for capital schemes referred to above.

Direct comparisons between sectors or authorities are not 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:

	General Fund	HRA
End of financial year:	%	%
2005/06 (actual)	4.0	24.8
2006/07	8.4	23.6
2007/08	10.4	22.8
2008/09	10.7	22.9
2009/10	9.9	22.1

The increase in the GF ratio in 2006/07 reflects the fact that the Net Revenue Stream no longer includes an element for schools budgets, following the introduction of the Dedicated Schools Grant.

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. The ‘incremental impact’ is defined as the *gross* budgetary impact of borrowing, before taking into account any Government funding. This overstates the budgetary impact, as some borrowing is partly funded by Formula grant, but it is considered to be the method most consistent with the Prudential Code, as in theory allocations of supported borrowing no longer have to be spent, meaning that all borrowing has an impact on the Council’s financial position.

The indicator below is calculated using the total borrowing, supported and unsupported, that is added annually to the capital programme. 'Spend to Save' schemes are excluded from the calculation as their approval is dependent on realisation of equivalent revenue savings.

On the basis of an interest rate of 4.75% for new borrowing, the impact of additional unsupported borrowing is as follows, all of which falls on council tax as there is no HRA unsupported borrowing planned:

	2007/08 £m	2008/09 £m	2009/10 £m
Total new borrowing	33.6	11.3	10.5
less Spend to Save schemes	-0.4	-0.1	-0.0
Net new borrowing	33.2	11.2	10.5
Repayment of principal - A	1.0	1.5	2.0
Interest payments 4.75% - B	0.8	1.8	2.3
Total revenue financing cost – C = A+B	**1.8**	**3.3**	**4.3**

In addition to financing capital expenditure from borrowing, the capital programme is also partly financed from useable capital receipts and direct charges to the revenue account. These methods also result in an impact on the revenue account. Use of capital receipts reduce the Council's balances available for investment and therefore will result in lower investment income. Capital funded by a revenue contribution has the direct impact of the amount funded. The following table demonstrates the revenue impact of schemes funded using these methods:

	2007/08 £m	2008/09 £m	2009/10 £m
Use of Capital Receipts	5.5	1.4	1.4
Cumulative average mid year	2.8	6.2	7.6
Reduced interest on Investments - D	0.2	0.3	0.3
Direct Use of Revenue - E	0.9	1.3	0.0
Total revenue cost – F = D+E	**1.1**	**1.6**	**0.3**

This gives the total revenue effect of the Council's capital programme as follows:

	2007/08 £m	2008/09 £m	2009/10 £m
Impact in year – G = C+F	**2.9**	**4.9**	**4.6**

The Prudential Code specifies that we must identify what the marginal cost on the council tax of these revenue budget costs should be. The marginal costs are as follows:

	2007/08 £.p	2008/09 £.p	2009/10 £.p
Cumulative effects:			
Borrowing: interest and principal– H	26.41	48.13	61.34
Use of Capital Receipts: lost interest – I	1.93	4.00	4.86
Total – J = H+I	28.34	52.13	66.20
One-off effects:			
Total in year – K = J for year	28.34	23.80	14.07
Direct use of revenue – L = E / taxbase	12.81	18.47	0.00
Marginal Band D impact - M = K+L	41.14	42.27	14.07
Cumulative Band D impact – N = J+L	41.14	70.60	66.20

The Government is still providing some support for capital financing costs to local authorities in Formula grant, even though it is no longer fully funded. The calculation above errs on the side of prudence by treating all supported borrowing as a cost and not attempting to reduce that cost by the element of grant allocated for supported borrowing – currently 31% of the costs are covered. Overall financing costs are taken into account in the Treasury Management budget within the revenue budget proposed to 1st March 2007 Council, and this element of the budget is still considered to be affordable.

In summary, the proportion of the Council's spending on debt is continuing to increase, albeit at a much slower rate than in previous years, and it remains at affordable levels.

The third affordability indicator is **the impact on council housing rents**. The Estates Pride programme includes an estimated element of capital spending, financed by the HRA, and the HRA also spends an allocation of SCE(R) of £1m a year. While these costs are indicated below, the real impact on rents is nil as rent policy is governed by the need for rent convergence under rent restructuring. There has therefore been no direct impact on the level of individual rents for these sources of funding.

The notional impact on council rents is therefore set out below:

	2007/08 £m	2008/09 £m	2009/10 £m
Borrowing cost – gross	1.00	1.00	1.00
Cumulative average mid year borrowing	0.50	1.50	2.50
Interest loss	0.02	0.07	0.12
Estates Pride estimated capital	2.24	2.00	3.00
Total cost	2.26	2.07	3.12
Notional impact on weekly rent £/week	**3.18**	**2.91**	**4.37**

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. As in previous years, the formal indicator has been supplemented by local indicators for borrowing and lending separately, in order to aid clarity. The following indicators are proposed for 2007/08:

Net exposure to interest rates:

	Upper Limit % of principal	Lower Limit % of principal
Fixed rate	120	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 supplementary 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 2006/07.

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	45	0
> 5 years and <10 years	75	0
> 10 years	100	25

These indicators indicate that the plan 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 authorities to set a limit on non-specified investments. Non-specified investments tend to be of higher risk than specified investments, and are categorised as follows:

- Term deposits with a maturity of greater than 1 year
- Supranational bonds with a maturity of greater than 1 year
- Gilt-edged securities with a maturity of greater than 1 year
- Building Societies without a credit rating
- Any non-rated subsidiary of a credit-rated institution
- Share capital or loan capital in a corporate body

The only items on this list approved within the Treasury Management Strategy are term deposits, non-credit-rated building societies or non-rated subsidiary of a credit-rated institution. The proposed limits for term deposits greater than 1 year is £45m and greater than 2 years is £25m. As previously approved by Council, no investments will be made for a period of more than 3 years.

Within these limits it is also proposed that a further limit of £20m be placed on investments with building societies without a credit rating, and other non-rated subsidiaries of credit-rated institutions, as set out in Annex 1 of the Treasury Management Strategy. Although our treasury management advisors state that all the top 20 building societies and non-rated subsidiaries of credit-rated institutions can be considered to be particularly low risk, investments with those that have not sought to secure a formal credit rating must be classed as non-specified, which is why this second limit should be applied. No investments greater than 24 months will be made with this category of counterparty.

APPENDIX 3

Treasury Management Strategy 2007/08

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 the capital programme using up to £10.5m of borrowing during 2007/08, aiming to borrow this amount at the most advantageous interest rates available during the year. At February 2007, investment interest rates remain favourable so it is prudent to retain our currently relatively high cash balances. However, if interest rates become unfavourable in the short term at any time during 2007/08, and there is a prospect of lower rates later, this gives the Council the option of running 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 advisors.

1.3 The Council will also review, in consultation with our advisers, PWLB debt-restructuring opportunities in pursuit of cost savings.

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 the appropriate limit for investments beyond a year be changed as follows:

	Current	Proposed
12-24 months	£35m	£45m
24-36 months	£35m	£25m

This would allow the Council to benefit further from higher rates available on longer-term investments.

1.5 In January 2007, the Bank of England base rate was increased to 5.25%. Our treasury management advisers are currently forecasting that will rise again to 5.50%, with a return to 5.25% by late 2007 / early 2008. However, this forecast may be changed by our advisors, depending on market conditions. The general strategy toward investments is to undertake either short or long dated investments that outperform market expectations, as informed by our treasury advisors. Market rates will inevitably move during the year, 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 2006/07 has broadly reflected actual market movements. PWLB borrowing has been taken at an average rate of 4.31% for an average term of around 36.2 years. The average return on investments to date of 5.00% has outperformed the average Bank of England base rate of 4.75% for 2006/07. However, such performance cannot be guaranteed each year, and it would be imprudent to budget on the assumption that the Council will continue to outperform the markets, although this will continue to be our aim.

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 2007/08, which have been produced in consultation with its external treasury consultants.

3. BORROWING STRATEGY

3.1 In determining Derby's borrowing strategy for 2007/08, account has been taken of:

- the latest regulatory framework
- the existing borrowing structure
- potential borrowing requirement for the year
- 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 2007, the Council's expected level of external debt is £339.9m against an expected capital financing requirement for the same date of £340.5m. This debt consists primarily of loans totalling £317.2m from the Public Works Loan Board at a weighted average rate of 4.96% together with market loans of £22.7m taken as Lender's Option Borrower's Option, LOBO, loans at 4.45%. The expected average for the combined PWLB and LOBO portfolio is 4.92%.

3.4 Borrowing during 2006/07

2006/07 borrowings are expected to total £78.750m, including rescheduling of existing debt of £58.75m, and £20m of new borrowing, having been taken at a weighted average rate of 4.31%. This has broadly reflected actual market movements and compares with average PWLB rates for 20-25 year and 45-50 year loans of 4.54% and 4.33% respectively. The Council took advantage of relatively low rates during the year, borrowing £8m at 4.25% in August 2006, £7m in September 2006 at 4.05%, and £5m in January 2007 at 4.25%.

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 previous years, 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 of restricting any one year to 15% of the portfolio, is proposed for 2007/08:

	Upper Limit %	Lower Limit %
Under 1 year	15	0
> 1 year and < 2 years	15	0
> 2 years and < 5 years	45	0
> 5 years and < 10 years	75	0
> 10 years	100	25

This structure gives the Council considerable flexibility to pursue the best value borrowing rates depending on market. It also allows sufficient flexibility to take advantage of potential restructuring opportunities.

3.6 Borrowing Requirement

The maximum amount the authority expects to borrow over the next three years to fund planned and previous capital expenditure is currently £30.8m. This has been calculated as follows:

	07/08 £m	08/09 £m	09/10 £m
New borrowing using central government Supported Capital Expenditure (Revenue) allocations for year	10.1	9.4*	9.4*
Unsupported Borrowing and Spend to Save schemes	23.5	2.9	2.1
PFI adjustment	-0.3	-0.3	-0.3
Potential borrowing requirement	33.3	12.0	11.2
Less: earmarked for repayment of debt	-8.2	-8.7	-8.6
Net increase in expected debt (CFR)	**25.1**	**3.3**	**2.6**

** These figures are estimates at this stage, as the government have not made any announcements relating to these years at this point.*

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 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.

In the past, the Council has also taken decisions to borrow from the market and currently holds £22.7m in the form of LOBO loans of 40 years duration. The decision reflected exceptional uncertainties. The extension of the available term of PWLB loans beyond 25 years up to 50 years during 2005/6 has removed much of the future advantage of LOBOs and we do not expect to take out further LOBOs in 2007/08.

Funds created internally come primarily from the amount the authority must set aside from the revenue account to meet debt repayments, known as the minimum revenue provision, or MRP. The timing of the use of these funds is left for the authority to manage.

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. Their observations are discussed below.

Current advice from our advisers is that long dated PWLB debt continues to offer the best value for borrowing, and that commitment to medium dated debt should be avoided. PWLB rates are expected to rise from current levels during 2007/08, but to drop back slightly towards the end of the financial year. Any substantive reliance on variable debt should also be avoided whilst fixed rates are low, as it would leave the Council exposed to interest rate increases.

The Council is in the financial position of not having to rely on any variable debt borrowing and with the exception of the LOBO loans mentioned in paragraph 3.3, where the Council can limit the extent of variability, it has been avoided. It is planned to continue this policy in 2007/08. 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. We are well within this limit where our highest maturity year is 2029/30 is currently 7.72% of our overall debt is due to mature.

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 PWLB loan facility of up to 50-year duration remains attractive based on the current shape of the yield curve, and some loans of close to this duration are likely to be taken. Given this, it is expected that the average length of outstanding debt will again increase during 2007/08.

Although our advisors are currently forecasting a base rate fall late in 2007, the need for variable rate debt remains doubtful. The Council retains significant surplus cash balances, and so the option remains, as in previous years, to consider deferring borrowing and instead running down cash balances over the year. The extent to which this may occur 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 both sensitive and flexible enough to react to the volatility of market sentiment.

Options are available to the Council to reschedule further long-term loans in 2007/08, which may be running at disadvantageous interest rates, or where savings can be made to reduce the debt charge costs to the authority. The Council’s external treasury advisors will continue to provide rescheduling forecast models to determine the financial implications of repaying or replacing specific loans, which may be acted upon under delegated powers.

4. ANNUAL INVESTMENT STRATEGY

4.1 The Council, in devising its annual Investment Strategy, must have regard to Government guidance on Local Government Investments issued in 2004, which introduced the then new prudential capital finance system. Prudent investment practices are still encouraged, but without the same detailed prescriptive regulation.

This strategy satisfies the requirements of both the CIPFA Code of Practice on Treasury Management as well as Government guidance, which 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 that 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.

4.3 Base rates have been increasing during 2006/07, having been 4.5% until August 2006 and are now 5.25%, averaging 4.75% to date. During this period, the Council has secured an average return on external investments of 5.00%, some 25 basis points higher than the base rate average. Our advisers forecast that the current base rate of 5.25% is likely to increase to 5.50% during 2007, with a return to 5.25% by late 2007 / early 2008. It is normal however, for forecasts to change as market conditions change.

4.4 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 continue to take either short- or long-dated investments with the aim of outperforming market expectations, informed by the view of our treasury advisers.

4.5 Short-term cash available for investment has fluctuated between £104m and £146m so far during 2006/07 and has averaged £130m. It has been invested only with institutions on the Council's approved list with restrictions on overall amounts for particular institutions and sectors. These levels of available cash are likely to reduce in 2007/08, as we anticipate settling our employees' equal value pay claims and spending capital and revenue reserves.

4.6 Annex 1 details the Specified Investments lending criteria, including the maximum lending limits and terms for individual counterparties and sectors. This is unchanged from 2006/07.

4.7 Government investment guidance 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 increase to a maximum of £45m, the amount of the Council's investment portfolio that can be prudently committed to beyond 12 months.

4.8 Those investment opportunities that will be classified as Non-Specified Investments under government guidance are shown at Annex 2 on pages 23 & 24. It is necessary to specify in this strategy those investments that 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 which instruments to include in the strategy:

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

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
- Unrated building societies
- Unrated subsidiaries of credit rated institutions

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

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. In addition, no investment of period greater than 12 months will be carried out without the express consent of the Director of Resources.

4.9 At this time, the current approved investment criteria are considered sufficient for 2007/08. However, the authority's lending list for specified and non-specified investments will as usual, be continually reviewed during 2007/08 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.

4.10 The following are the limits that are proposed to be maintained specifically for the council's lending for 2007/08:

	Upper Limit % of principal	Lower Limit % 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.

4.11 When placing money with counterparties, the CIPFA Code of Practice for Treasury Management states that it is best practice to spread investments between brokers and direct dealing counterparties, subject to the rates offered. The Council currently uses 6 brokers:

- Prebon
- Tradition
- Sterling
- London Currency Brokers
- ICAP
- Martins

and 5 direct counterparties for money market deals being:

- Barclays
- AIM Global
- Gartmore
- Standard Life and
- Royal Bank of Scotland.

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 institution's 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:

Short Term	Long Term	Individual	Support	Limit
F1+	AA	A or B	3	£15m
F1	A	A or B	3	£10m
Other top 20 Building Societies, but without a credit rating				£6m
Other subsidiaries of institutions meeting the above criteria, but without their own credit rating				£3m

Our treasury advisors state that all of the top 20 building societies can be considered to be particularly low risk, even where they have not sought to secure a formal credit rating.

Sector Limits

2006/07 sector limits, based on the existing criteria above are as follows:

Sector	Sector Limits
	Max % of portfolio
UK and Foreign Banks	70%
UK Building Societies	70%

It is proposed to maintain these sector limits.

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 that an institution might 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

In practice the Council has two kinds of non-specified investment:
- Investments with non-rated top-20 building societies.
- Investments in any institution that financially commit the Council for a period of greater than 12 months.

Occasionally, investments may fall into both these categories.

Investments with building societies that do not have an official credit rating, or with other non-rated subsidiaries of institutions with a credit rating, are non-specified. To reflect this increased risk, a counterparty limit of £6m will apply to every top-20 building society with no credit rating. A £10m limit applies to those with a rating. Non-rated building societies, however, are in every other way as secure as a specified investment.

The maximum limit for non-specified investments of greater than 12 months is £45m. The maximum term for any investment is 3 years. Within the £45m limit, a separate limit of £20m applies to investments with non-rated institutions, but such investments will be restricted to a maximum of two years.

The following non-specified investments are considered to be in keeping with the Council'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
Unrated building societies and subsidiaries	No	- Certainty of rate of return - Certainty of capital value - Potentially higher rate of return than banks

The following non-specified investments, whilst allowable under the Government's 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

APPENDIX 4

Prudential Code Indicators Summary 2005/06 - 2009/10

Prudential Code Reference	Indicator	Actual 2005/06	Estimated 2006/07	Estimated 2007/08	Estimated 2008/09	Estimated 2009/10
Affordability						
	Forecast Financing cost to Net Revenue Stream Ratio					
35	- General Fund %		8.40%	10.40%	10.72%	9.95%
36	- HRA %		23.55%	22.78%	22.91%	22.13%
	Actual Financing cost to Net Revenue Stream Ratio					
37	- General Fund %	4.03%				
38	- HRA %	24.76%				
39	**Incremental Impact on Council Tax: Band D £/year cumulative**			41.14	70.60	66.20
39	**Incremental Impact on Council Tax: Band D £/year year's programme**			41.14	42.27	14.07
40-41	**Incremental Impact on Housing Rents £/week - year's programme = cumulative**	0.44	0.79	3.18	2.91	4.37
Prudence						
45	**Actual / Forecast Borrowing compared to CFR**					
	-Net External Debt £m	224.3	248.2	295.4	309.7	328.7
	- CFR £m	322.5	340.5	365.5	368.7	371.3
Local	- Gross External Debt £m	328.5	340.2	365.3	368.5	371.2
	- CFR £m	322.5	340.5	365.5	368.7	371.3
Capital Expenditure						
51-52	**Total Capital Expenditure**					
	- General Fund £m	45.3	73.0	99.1	48.8	35.0
	- HRA £m	31.1	10.3	10.7	10.6	11.7
	- Total £m	76.4	83.3	109.8	59.4	46.6
53-54	**Estimated Capital Financing Requirement**					
	- General Fund £m	134.0	151.0	175.0	177.2	178.8
	- HRA £m	188.5	189.5	190.5	191.5	192.5
	- Total £m	322.5	340.5	365.5	368.7	371.3
57-58	**Actual Total CFR £m**	322.5				
External Debt						
59	Authorised Limit for borrowing £m	387	440	439	443	446
	Authorised Limit for other long term liabilities £m	1	1	1	1	1
	Authorised Limit £m	388	441	440	444	447
60	Operational Boundary for borrowing £m	322	340	366	369	372
	Operational Boundary for other long term liabilities £m	1	1	1	1	1
	Operational Boundary £m	323	341	367	370	373
Treasury Management						
66	**Adopted CIPFA Treasury Management Code of Practice**	Yes	Yes	Yes	Yes	Yes
67-70	**Interest Rate Exposure - Fixed**					
	Upper limit %	101.92	120	120	120	120
	Lower limit %		80	80	80	80
67-70	**Interest Rate Exposure - Variable**					
	Upper limit %	-1.92	20	20	20	20
	Lower limit %		-20	-20	-20	-20
Local	**Long term Borrowing - Fixed rate**					
	Upper limit %	93.09	100	100	100	100
	Lower limit %		80	80	80	80
Local	**Long term Borrowing - Variable rate**					
	Upper limit %	6.01	20	20	20	20
	Lower limit %		0	0	0	0
Local	**Investments - Fixed rate**					
	Upper limit %	73.18	100	100	100	100
	Lower limit %		30	30	30	30
Local	**Investments - Variable rate**					
	Upper limit %	26.82	70	70	70	70
	Lower limit %		0	0	0	0
74	**Maturity Structure of Debt - % of all debt**					
	Under a year	2.47				
	Between 1 and 2 years	6.95				
	Between 2 and 5 years	4.96				
	Between 5 and 10 years	7.32				
	Over 10 years	78.3				
77	**Investments over a year - limit £m**	£15m	£35m	£45m	£45m	£45m
Local	**Investments over two years - limit £m**			£25m	£25m	£25m
Local	**Investments with approved unrated institutions limit £m over 1 year < 2 yr**			£20m	£20m	£20m