DERBY CITY COUNCIL

COUNCIL CABINET
21 FEBRUARY 2006

Cabinet Member for Corporate Policy

Treasury Management Strategy and Prudential Code Indicators 2006/7

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 2006/07, taking into account the prudential indicators proposed for future years.

1.3 Appendix 3 identifies that both borrowing and investment decisions taken during 2005/06 to date have had a positive impact on the Council's finances, reducing the budgeted average borrowing rate by 0.14% overall, with investments outperforming the average Bank of England base rate by 0.05%.

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

RECOMMENDATION

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

2.2 To recommend Council to adopt the Treasury Management Strategy for 2006/07, 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 all local authorities to 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

Treasury Management Strategy and Prudential Code Indicators 2006/7

SUPPORTING INFORMATION

1.1 From April 2004, the Local Government Act 2003 removed the 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.

1.2 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

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 2006/07 to 2008/09, 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 intended to be 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 GF debt are rising, it is only a very gradual increase and does not undermine the sustainability and affordability.

1.6 In previous years, the Council, with the agreement of its auditors, had defined the affordability measures in terms of cost only of ‘unsupported’ borrowing above that approved by Government, assuming that other ‘supported’ borrowing was in effect fully funded. Changes to the revenue support grant system for 2006/7 require a change to this approach. From 2006/7, in the first year of a capital scheme only 15% of the marginal cost of financing ‘supported’ capital expenditure will be funded fully from revenue support grant, at the margin, although this will increase in later years. This is due to the operation of the system of floors within the grant system, which was explained in the Cabinet report of 20 December 2005 on the local government finance settlement. 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 on housing revenue account services continues to be fully funded.

1.7 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.

1.8 Most of the proposed prudential indicators are explained in detail at 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. The prudential indicators other than those relating to affordability are all set on a basis consistent with the approach taken in previous years.

1.9 The Treasury Management Strategy proposed for 2006/07 is also generally consistent with the approach taken in previous years. Exceptions are that …

- The Cabinet, at its meeting on 29 November 2005, authorised the Director of Finance to borrow in advance of 2006/07, as prevailing borrowing rates were low and forecast to be significantly higher in 2006/07. Since that date, £15m has been borrowed from the PWLB at advantageous rates of interest. This has enabled us to propose a lower Treasury Management budget for 2006/07 than would have been possible had the borrowing not taken place. The Strategy leaves open the option of undertaking further advanced borrowing in 2006/07 for 2007/08, if necessary, subject to the constraints imposed by the prudential indicators.

- During 2005/6, the PWLB changed its policy to make available loans of a longer duration than 25 years, and it is now likely that some long dated loans will be taken for up to 50 years duration. Because of this the average term of the Council’s borrowing is likely to increase.

- Given the availability of 50 year PWLB loans, market loans including LOBOs now appear less attractive and it is not planned to take any such loans without further authorisation.

1.10 The Treasury Management Strategy also sets out details of investment and borrowing performance during the current year, 2005/06. Investment performance has compared favourably with the market, with returns over the year to date averaging around 4.65%, having consistently outperformed both Bank of England Base Rate and all money market rates up to 12 months. As stated above, the Council has also continued to take advantage of lower long term borrowing rates, including an £8m rescheduling of debt in January 2006. The Council's debt is now held at an average rate of 5.06% compared to a rate of 6.0% assumed by the Government to be typical of local authorities for 2006/07. This performance is reflected in the Treasury Management budget estimates for 2006/07 to 2008/09, which are included within the proposals put forward for adoption by Cabinet.

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Background papers:	None
List of appendices:	Appendix 1 - Implications Appendix 2 - Prudential Indicators Appendix 3 - Treasury Management Strategy 2006/07 Appendix 4 - Prudential Indicator Summary 2006/07

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 2006/07

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 2006/07 to 2008/09, which the Council will approve on 1 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 2006/07 to 2008/09. The first indicator is the plan for Capital expenditure for the next three years:

	General Fund (GF)	HRA	Total
	£m	£m	£m
2006/7	68.0	10.1	78.1
2007/8	55.4	10.7	66.1
2008/9	39.2	10.7	49.9

Actual capital expenditure for 2005/06 will be recorded and reported after the end of the financial year. Latest estimates are total spend of £80.4m, of which £49.5m relates the GF and £30.9m to the HRA. The actual capital expenditure for 2004/05, as reported to Cabinet in July 2005 was £88.3m, of which, £39.2m related to the GF, and £49.1m to the HRA. The substantial reduction in the HRA element from 2006/07 is due to the planned completion of the Homes Pride programme.

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
2004/5 – actual	162.6	163.9	326.5
2005/6 – projected	173.3	189.2	362.6
2006/7	188.5	190.2	378.7
2007/8	194.1	191.2	385.3
2008/9	196.8	192.2	389.0

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.

The *Operational Boundary* for borrowing needs to be set higher than the expected CFR for each year, in order to prevent the need to report every small movement above it, and to allow for variability in the exact timing of borrowing and spending. For example, on 29 November 2005, the Cabinet gave authority to bring forward external borrowing for 2006/07 to take advantage of market conditions. Also, further borrowing on 'spend to save' schemes and additional government funded borrowing may also be approved. As these factors can be volatile, a sensible level of operational boundary is difficult to set. If it is set too high it is never used, and if too low, would be triggered too often. Specific guidance from the government or CIPFA on appropriate levels is still limited and it is left to an authorities' own judgement. An appropriate level for the operational boundary was set at 10% above the CFR in 2004/05 and 2005/06. It is considered that this level has provided sufficient necessary flexibility including the potential for further advanced borrowing or temporary additional borrowing to fund debt restructuring if required, whilst not providing excessive headroom. It is therefore proposed to maintain the limit at this level.

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. It was considered that a lower limit for 2005/06 and future years of 15%, or £54m above the expected level of borrowing would be more appropriate. A breach of this limit is not permitted by legislation, however 15% has proved sufficient and it is proposed to maintain it at that level.

The limits proposed for approval are set out below:

End of financial year:	Operational Boundary £m	Authorised Limit £m
2006/7	417	435
2007/8	424	443
2008/9	428	447

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

End of financial year:	Operational Boundary £m	Authorised Limit £m
2006/7	1	1
2007/8	1	1
2008/9	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 (2008/09). In addition to the formal indicator, a further local indicator has been shown to include debt 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 2006/07 and subsequent years in the absence of further advanced borrowing. For 2005/06, the local indicator shows that borrowing including transferred debt, temporarily exceeds the indicator as the CFR has been revised downwards following slippage in the capital programme, and some advanced borrowing for the 2006/07 programme has also been undertaken.

Financial year End	External Debt Excl. externally managed debt	External Debt Incl. externally managed debt	CFR
	£m	£m	£m
2004/5 - actual	285.5	337.8	326.5
2005/6 - probable	328.5	378.8	362.6
2006/7	328.6	376.9	378.7
2007/8	335.2	381.7	385.3
2008/9	338.9	383.5	389.0

4 Affordability

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

With the new 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 all borrowing beyond government limits is no longer illegal, but has to paid for by the Council from within its own funding streams, that is, the council tax or housing rents.

In 2005/06 and previous years, the government effectively funded the majority of non-prudential borrowing, either through capital financing FSS or HRA subsidy. From 2006/7, in the first year of a capital scheme only 15% of the marginal cost of financing 'supported' capital expenditure will be funded fully from revenue support grant, at the margin, although this will increase in later years. This is due to the operation of the system of floors within the grant system, which was explained in the Cabinet report of 20 December 2005 on the local government finance settlement. 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 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)	Corporate Unsupported Borrowing	Service Financed Unsupported Borrowing	Approved Spend to Save Borrowing	Total Borrowing
	£m	£m	£m	£m	£m
2005/6	33.3	3.1	2.7	1.4	40.5
2006/7	16.4	2.2	2.1	1.3	22.0
2007/8	9.6	2.0	1.1	0.8	13.5
2008/9	8.7	2.0	0.2	0.1	11.0

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:

End of financial year:	GF	HRA
	%	%
2006/7	8.4	22.2
2007/8	9.2	22.4
2008/9	9.3	21.9

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

2003/4 - Actual	4.21	23.6
2004/5 - Actual	3.82	21.4
2005/6 Probable	4.12	23.8

The increase in the GF ratio from 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. This can be interpreted in several ways, and our external auditors have to date accepted the Council's interpretation that only unsupported borrowing has any net budgetary impact, and other borrowing could be ignored for the calculation. The changes in the way that Government support is provided for general fund services require a change in treatment.

The new treatment proposed is to show the gross budgetary impact of borrowing, before taking into account any Government funding. This will overstate the net budgetary impact, but is considered to be consistent with the Prudential Code.

The revised 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 that the new assets will be paid for over 25 years, and using 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:

	2006/7 £m	2007/8 £m	2008/9 £m
Total new borrowing	21.0	12.5	10.0
Less 'Spend to Save' schemes	1.3	0.8	0.1
Net new borrowing	19.7	11.7	9.9
Cumulative average spent mid year	9.8	25.6	36.4
Repayments of principal (4%) – A	0.00	0.79	1.22
Interest payments – B 4.75% of average	0.47	1.21	1.73
Total revenue financing cost C= (A+B) £m	0.47	2.00	2.95

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 of 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:

	2006/7 £m	2007/8 £m	2008/9 £m
Use of Capital Receipts	7.70	2.30	1.90
Cumulative average spend mid year	3.90	8.90	11.00
Reduced Interest on Investments – D	0.17	0.38	0.46
Direct Use of Revenue – E	1.60	2.20	2.20
Total revenue cost F=D+E	1.77	2.58	2.66

	2006/7 £m	2007/8 £m	2008/9 £m
Impact in year C+F	2.24	4.58	5.61

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:

	2006/7	2007/8	2008/9
Cumulative effects:	£	£	£
Borrowing (interest and MRP) = 1	6.78	28.84	42.52
Use of Capital Receipts (lost interest) = 2	2.46	5.48	6.63
Total: 3 = 1+2	9.24	34.32	49.14
Total – in year: 4 = 3 for the year	9.24	25.08	14.82
One off effects:			
Direct revenue financing: 5	23.20	31.70	31.70
Marginal Band D impact per year = 4+5	32.44	56.78	46.52
Cumulative Band D impact = 3+5	32.44	66.02	80.84

The impact on the revenue budget shown above is the gross marginal impact rather than the net impact. The Government is still providing support for capital financing costs to local authorities in revenue support grant, even though that is no longer fully linked to authorities individual schemes. The calculation therefore errs on the side of prudence. The overall gross financing costs are taken into account in the Treasury Management budget within the revenue budget proposed to 1 March 2006 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 rising, but it remains at affordable levels.

The third affordability indicator is the **impact on council housing rents**. The introduction of the Estates Pride programme will include an estimated element of capital spending, financed by the HRA. The cost indicated below is notional, as borrowing costs are fully covered by housing subsidy, and 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 of these sources of funding.

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

	2006/07	2007/08	2008/09
	£m	£m	£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	1.14	2.15	2.20
Total cost	1.16	2.22	2.32
Notional cost per week average rent	1.61	3.15	3.34

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 2006/07:

Net exposure to interest rates: As in previous years, the formal indicator 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 2005/06.

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 is 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 2006/07

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 £23m of borrowing during 2006/07, aiming to borrow this amount at the most advantageous interest rates available during the year. £15m of this has already been financed from advanced borrowing during 2005/06 to take advantage of particularly low interest rates of between 3.70% and 4.25% between December 2005 and January 2006, for terms of 25 to 50 years. If interest rates are unfavourable in the short term, but 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 advisers.

1.3 The Council will also review 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 and for non-specified investments as a whole be maintained at £25m. No changes are proposed to the other limits applying to particular types and classes of investments.

1.5 At the end of January 2006, the Bank of England base rate was forecast by our treasury advisers to fall to 4.25% by March 2006, then remaining constant for the majority of 2006/07, but rising back to 4.50% towards the close of the year. The general strategy toward investments is to undertake either short or long dated investments that outperform market expectations, as informed by our treasury advisers. 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 2005/06 has broadly reflected actual market movements. PWLB borrowing has been taken at an average rate of 4.22% for an average term of around 31years. This has had the impact of reducing the Council's average external borrowing rate from a budgeted 5.20% to a probable 5.06%. The average return on investments to date of 4.65%, has outperformed the average Bank of England base rate of 4.60% for 2005/06. Such 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.

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 2006/07, which have been produced in consultation with its external treasury consultants.

3. BORROWING STRATEGY

3.1 In determining Derby's borrowing strategy for 2006/07, 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 2006, the Council's expected level of external debt is £328.5m against an expected capital financing requirement for the same date of £362.6m. This consists primarily of loans totalling £305.8m from the Public Works Loan Board at a weighted average rate of 5.11% together with market loans of £22.7m taken as Lenders option, Borrowers option (LOBO) loans at 4.45%. The expected average for the portfolio is 5.06%.

3.4 Borrowing during 2005/06

2005/06 borrowings, including the £15m taken in advance of 2006/07 are expected to total £43.0m, having been taken at a weighted average rate of 4.22%. This has broadly reflected actual market movements and compares with average PWLB rates for 25 and 50 year loans of 4.40% and 3.97% respectively. Loans beyond 25 years duration only became available following a change in PWLB policy in December 2005. A historic low point in PWLB rates was reached in January 2006, and the Council took advantage of this to undertake advanced borrowing for 2006/07 and some debt restructuring.

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, was approved by Cabinet for 2005/06 and is proposed again for 2006/07:

	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 should interest rates be high when refinancing debt. It also allows sufficient flexibility to take advantage of potential restructuring opportunities.

3.6 2006/07 Borrowing Requirement

The maximum amount the authority expects to borrow during 2006/07 to fund planned and previous capital expenditure is currently £9.2m. This has been calculated as follows:

	£m
2005/06 borrowing in excess of CFR	(1.3)
New borrowing using central government Supported Capital Expenditure (SCE)R allocations for 2006/07	16.4
Unsupported Borrowing and Spend to Save schemes	5.7
Long Term loan repayments 2006/07	8.1
Potential borrowing requirement 2005/06	28.9
Less: earmarked for repayment of debt	5.9
Net increase in expected debt (CFR)	23.0
Less: Borrowing in Advance of 2006/07	15.0
Expected Maximum Borrowing 2006/07	8.0

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 further such loans are not now expected to be taken in 2006/7.

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, or 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 offers 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 2006/7, but to drop back slightly towards the end of the financial year. Any substantive reliance on variable debt should also be avoided whilst rates are low as it would leave the Council exposed to market rises, 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 new PWLB loan facility of up to 50 year duration appears 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 increase slightly during 2006/7.

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. Although a significant amount of borrowing has already taken place in respect of 2006/07, the strategy will remain, as in previous years, to consider if appropriate, the option of 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 sensitive to the volatility of market sentiment.

Should borrowing rates remain reasonably close to the historic lows in 2005/6 and well below levels they are expected to reach in 2007/8, further advanced borrowing may be considered during 2006/7, within the limits permitted by the prudential indicators.

Options are available to the Council to reschedule further long-term loans in 2006/07, 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.

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 have been relatively flat during 2005/06, having been 4.75% until August 2005 and 4.50% since, averaging 4.60%. During this period, the Council has secured an average return on external investments of 4.65%. Our advisers predict that the current base rate of 4.50% is likely to remain stable, with a possible 0.25% movement down, moving back up to 4.50% by the end of 2006/07. 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 continue 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 £81m and £138m so far during 2005/06 and averaged £115m. 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 2006/07 will reflect similar levels, unless there is a significant change in the Capital Programme and the relevant funding arrangements.

4.5 Annex 1 details the Specified Investments lending criteria, including the maximum lending limits and terms for individual counterparties and sectors. This is unchanged from 2005/06.

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 At this time, the investment criteria approved for 2005/06 are considered sufficient for 2006/07. However, the authority's lending list for specified and non-specified investments will as usual, be continually reviewed during 2006/07 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.

4.9 The following are the limits that are proposed to be maintained specifically for the council's lending for 2006/07:

	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.

4.10 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:

Short Term	Long Term	Individual	Legal/Support	Limit
F1+	AA	A or B	3	£15m
F1	A	A or B	4	£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				3 months

Our treasury advisers 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. 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

2005/06 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 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 2006/07 - 2008/09

Prudential Code Reference	Indicator	Actual 2004/05	Estimated: 2005/06	2006/07	2007/08	2008/09
Affordability						
35 - 36	**Forecast Financing cost to Net Revenue Stream Ratio**					
	- General Fund %		4.12%	8.40%	9.20%	9.34%
	- HRA %		23.84%	22.19%	22.37%	21.94%
37-38	**Actual Financing cost to Net Revenue Stream Ratio**					
	- General Fund %	3.82%				
	- HRA %	21.41%				
39	**Incremental Impact on Council Tax: Band D £/year**			32.44	56.78	46.52
Local	**Marginal Impact on Council Tax: Band D £/year per £1m extra revenue cost - full year effect**			14.50	14.41	14.41
40-41	**Incremental Impact on Housing Rents £/week**			1.61	3.15	3.34
Prudence						
45	**Actual / Forecast Borrowing compared to CFR**					
	- External Debt excluding Transferred Debt £m	285.5	328.5	328.6	335.2	338.9
	- CFR £m		362.6	378.7	385.3	389.0
Local	- External Debt including Transferred Debt £m		378.8	376.9	381.7	383.5
	- CFR £m		362.6	378.7	385.3	389.0
Capital Expenditure						
51-52	**Total Capital Expenditure**					
	- General Fund £m			68.0	55.4	39.2
	- HRA £m			10.1	10.7	10.7
	- Total £m			78.1	66.1	49.9
53-54	**Estimated Capital Financing Requirement**					
	- General Fund £m		173.3	188.5	194.1	196.8
	- HRA £m		189.2	190.2	191.2	192.2
	- Total £m		362.6	378.7	385.3	389.0
57-58	**Actual Total CFR £m**	326.5				
External Debt						
59	Authorised Limit for borrowing £m			435	443	447
	Authorised Limit for other long term liabilities £m			1	1	1
	Authorised Limit £m			436	444	448
60	Operational Boundary for borrowing £m			417	424	428
	Operational Boundary for other long term liabilities £m			1	1	1
	Operational Boundary £m			418	425	429
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**			£25m	£25m	£25m
	Additionally, no investment to be longer than two years from date of investment					