DERBY CITY COUNCIL

COUNCIL CABINET
24 FEBRUARY 2004

ITEM 19

Report of the Director of Finance

PRUDENTIAL CODE FOR CAPITAL AND TREASURY MANAGEMENT STRATEGY

RECOMMENDATIONS

1.1 To recommend Council to approve the planned prudential indicators set out in Appendix 3 to this report.

1.2 To adopt the Treasury Management Strategy set out in Appendix 2 to this report.

REASON FOR RECOMMENDATIONS

2.1 The full Council is obliged under the Local Government Act 2003 to approve prudential indicators relating to its planned use of capital borrowing for the next three years. This report is intended to set those indicators.

2.2 The CIPFA Code of Practice for Treasury Management requires approval of a Treasury Management Strategy. The proposed strategy, attached at Appendix 2, is broadly similar to those approved in previous years, revised primarily to take account of current market conditions, changed legislative arrangements, and the estimated capital spending financing requirement for 2004/5.

SUPPORTING INFORMATION

3.1 The Local Government Act 2003 approved major changes to the system of capital controls on Local Authorities. Replacing the complex and detailed prescription of the Local Government and Housing Act 1989 is a new reliance upon prudential guidelines set by CIPFA.

3.2 Section 3 of the Local Government Act 2003 imposes a duty on the Council to determine and keep under review how much money it can afford to borrow. Having set that ‘Authorised Limit’ in line with the CIPFA Prudential Code for Capital Finance in Local Authorities, the authority may not exceed it. It may, however, make a new limit at any time. The Authorised Limit is an absolute limit on borrowing. In addition the Council must also set an ‘operational boundary’ for borrowing. This is a level of borrowing that, if exceeded frequently, indicates that there may be a problem with the borrowing strategy. These targets are required to be set for the next three financial years.

3.3 The government may, under Section 4 of the Local Government Act 2003, impose a limit on the borrowing of every local authority ‘for national economic reasons’, 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 provision will be used at the outset of the new system.

3.4 The Prudential Code sets out ‘to ensure that the capital investment plans of local authorities are affordable, prudent and sustainable’. In order to do this, a series of indicators that must be adhered to are set out. These are for the local authority to set itself, subject only to the controls of Section 4 of the Act. These indicators are to be considered together with the Treasury Management Strategy of the Council. This report therefore combines the setting of these new indicators with the established process of setting the Treasury Management Strategy.

3.5 The required indicators can be loosely grouped into the following categories:
- Plans for capital expenditure
- Borrowing Limits
- Affordability
- Treasury Management

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

3.7 The plans for capital expenditure obviously need to be consistent with the capital programme of the Council. Council will take final decisions on this on 1 March. The figures included in this report are based on the recommendations to the Cabinet, in the separate report on the capital programme.

3.8 The amount of capital spending expected to be undertaken is influenced primarily by the funding made available through government approvals, formerly known as Basic Credit Approvals, BCAs, now called Supported Capital Expenditure, SCE(R). This is supplemented by government grants for capital. There also remains the ability to apply capital receipts and to fund capital from revenue. In addition to these sources, the Local Government Act 2003 allows Councils to borrow further sums, known as ‘unsupported borrowing’, as long as such borrowing can be financed by the Council, and does not rely on additional financial support from the government.

3.9 The report on the proposed capital programme proposes that an anticipated level of £2m of unsupported borrowing should be undertaken in 2004/5 to support and increase the capital programme above the level that would otherwise have been possible. This is considered to be affordable within the existing plans of the Council, and will result in additional ongoing treasury costs of around £180,000 a year, the equivalent of approximately £2.70 a year, on Band D Council Tax. The Council may of course make savings or apply a proportion of general government grant support to offset this. Such unsupported borrowing is also planned in 2005/6 and 2006/7, with a similar ongoing cost associated with each year's programme.

Plans for Capital Expenditure

3.10 The first indicator is the plan for Capital expenditure for the next three years. This is set out below, in line with the proposed capital programme, contained in a separate report on this agenda:

	General Fund	HRA	Total
	£m	£m	£m
2004/5	34.0	33.5	67.5
2005/6	30.7	27.4	58.1
2006/7	34.3	8.3	42.6

3.11 Actual capital expenditure will be recorded and reported after the end of the financial year. The actual capital expenditure for 2002/3 was £37.0m General Fund, or GF, and £17.9m Housing Revenue Account, HRA.

Borrowing

3.12 One of the key indicators is the Council's expected Capital Financing Requirement, or CFR, which uses balance sheet figures to indicate the maximum amount of capital financing that is required by the Authority. This will increase as more resources are spent on creating or enhancing capital assets, but will reduce as debt is set aside, a grant is received, usable capital receipts are applied or revenue funding is used to fund capital expenditure by the Authority. Technically, the CFR is the sum of the following items on the balance sheet:

- Fixed Assets
- Deferred Charges

less

- Fixed Asset Restatement Reserve
- Capital Financing Reserve
- Government Grants Deferred.

In addition, any forms of credit arrangements are to be included in the total CFR. The CFR is therefore similar to the 'credit ceiling' calculation under the previous system.
The CFR is a best estimate at this stage of what is likely to happen given the capital programme as set out.

	General Fund	HRA	Total
CFR at the end of:	£m	£m	£m
2003/4	161.5	121.9	283.4
2004/5	169.6	147.7	317.3
2005/6	176.7	167.4	344.1
2006/7	192.7	168.2	360.9

3.13 The substantial increase in the HRA over the next couple of years is due to the anticipated completion of the Homes Pride programme, funded through government ALMO funding to the HRA. The increase in the General Fund reflects the plans made in the rest of the capital programme report, including the unsupported borrowing of £2m in each year.

3.14 The operational boundary for borrowing will need to be set higher than the expected level, to avoid reporting every small movement above the expected amount of borrowing. An element of variability in the exact timing of borrowing and spending is only to be expected, especially with a relatively proactive treasury policy to borrow for the future when interest rates appear to be favourable. No guidance has been offered by either the government or CIPFA on what an appropriate level should be, so it would appear sensible therefore to set the operational boundary at around 10% above the CFR. This amounts to £32m for 2004/5, and should avoid needless reporting of occasional breaches of the limit. Should additional supported borrowing, become available during the year, this would mean that the government was offering to effectively underwrite the costs of such borrowing in future. Additional mid-year supported borrowing should be containable within this limit, but any very exceptional increases might require a change to this limit. ‘Spend to Save’ schemes can also now be considered within the overall prudential code framework. It is suggested that any likely level of additional unsupported borrowing on such schemes can be contained within this limit. A further report to Cabinet will be necessary to set out the details of a ‘Spend to Save’ process.

3.15 Similarly the absolute limit on borrowing to be set is a matter for the Council to decide. A breach of this limit is not permitted by the legislation, and it is suggested that an initial limit be set at around 25% or around £80m above the expected level of borrowing, in order that the limit is not likely to be approached in the near future, requiring a new limit to be set, even if further supported borrowing was offered. It should be noted that the government effectively funds the majority of borrowing, either through capital financing FSS, or government grant. The increase in net indebtedness is therefore not necessarily putting additional pressure on the Council Tax, other than where unsupported borrowing takes place. It follows that the operational boundary and the authorised limit could be revised upward in future years, were the supported capital programme to grow, without putting additional pressure on the council tax.

3.16 The limits proposed for approval are set out below:

	Operational Boundary	Authorised Limit
End of financial year:	£m	£m
2004/5	350	400
2005/6	380	430
2006/7	400	450

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 remains the Council’s policy not to enter into new forms long-term liabilities other than borrowing, and the limit is therefore set to reflect only existing liabilities of this type.

End of financial year:	Operational Boundary £m	Authorised Limit £m
2004/5	1	1
2005/6	1	1
2006/7	1	1

Prudence

3.17 The Prudential Code requires a statement that the total net external borrowing excluding any transferred debt from other local authorities is less than the Council's CFR. This is to ensure that overall external borrowing exposure is not excessive. It is unlikely that the Council will approach this level of external borrowing in the foreseeable future. In addition to the formal indicator, a further, local indicator has been shown to include transferred debt from other local authorities, as these remain debts for which the Council is liable. This local indicator demonstrates that debt including transferred debt is also within the CFR, and this is met with reasonable comfort. The figures for Derby shown below demonstrate that total net external borrowing will be less than the CFR in 2003/4 and subsequent years:

End of financial year	External Debt Excl. Transferred £m	External Debt Including Transferred £m	CFR £m
2003/4	216.7	269.7	283.4
2004/5	253.5	304.4	317.3
2005/6	284.3	333.3	344.1
2006/7	297.4	344.5	360.9

3.18 The actual external debt excluding transferred debt at the end of the 2002/3 financial year was £183.1m. Including transferred debt, the total external debt of the Council stood at £238.2m

Affordability

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

3.20 The affordability measures required by the Prudential Code could therefore be regarded as the most important indicator in judging whether such borrowing is acceptable to the Council. Legal constraints have effectively been replaced by a more flexible financial constraint.

3.21 The indicators in this section relate separately to the General Fund, GF and Housing Revenue Account, HRA. In the case of the HRA it is not proposed to do any unsupported borrowing, and the figures therefore relate solely to the funded capital programme. Figures for the GF include £2m a year of unsupported borrowing. This excludes any additional unsupported borrowing or 'Spend to Save' schemes that might be approved by the Council. At the moment, therefore, the figures include unsupported borrowing of:

2004/5	£2.00m
2005/6	£3.92m
2006/7	£5.84m

These figures represent £2m a year of unsupported borrowing, reduced by 4% debt repayment each year, under the current arrangements for minimum revenue provision for the repayment of debt, or MRP.

3.22 The first indicator is the expected ratio of financing costs to the net revenue stream. This attempts to measure the relative level of debt costs in each authority. As explained earlier, the government will support the vast majority of such debt. Direct comparisons between the sectors or authorities are not therefore very meaningful other than to measure the overall level of such debts that are held. The indicators for Derby, based on unsupported borrowing of £2m a year and a continuation of MRP at the minimum level, are:

End of financial year:	GF %	HRA %
2004/5	4.46	19.72
2005/6	4.42	22.41
2006/7	4.53	23.28

3.23 These indicators for the current and previous years are as follows:

2002/3 Actual	4.09	23.37
2003/4 Estimated	4.31	22.71

It should be noted that the HRA financing costs will fall in 2004/5 due to the abolition of minimum revenue provision for the repayment of debt relating to the HRA, and in the absence of any additional voluntary debt repayment by the Council.

3.24 There is also a requirement to set an estimate of the incremental impact of capital investment decisions on the Council Tax. This is not defined precisely in the Prudential Code, but the Council's interpretation is believed to be consistent with most other local authorities. This is that the incremental impact represents 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. On the basis that the new assets will be paid for over 25 years, and using an interest rate of 5%, the impact of additional unsupported borrowing is as follows:

	2004/5	2005/6	2006/7
Total new prudential borrowing	£2m	£2m	£2m
Cumulative average spent mid year	£1m	£3m	£5m
Repayments of principal	-	£0.08m	£0.16m
Outstanding balance	£2m	£3.92m	£5.84m
Interest at 5% on average spent	£0.05m	£0.15m	£0.25m
Total cost	£0.05m	£0.23m	£0.41m
Impact on Council Tax (Band D / year)	75p	£3.45	£6.15

3.25 Another way of looking at this is that the increase in a full year is around £180,000 or £2.70 a year on Band D tax. In the first year, there is a lesser impact as the spending takes place throughout the year. Therefore while the immediate impact of the first £2m is 75p a year, the full year impact will be £2.70 a year on Band D. As a percentage of the Council Tax, the full year impact of an additional £2m is approximately 0.3%. Should further unsupported borrowing be approved by Council, this would impact on the Council Tax at around £1.35 a year on Band D for each £1m of new borrowing when applied over the full year.

3.26 The other indicators are generally based on estimated average interest rates for borrowing of 5.25%. This average is low for Derby, due to effective debt management, compared to the average of many authorities, indicated by government funding for interest costs in FSS being based on 6.6% interest rates for 2004/5. Such rates reflect the average of loans outstanding, not just the costs of new loans taken at current interest rates. In the longer term, the government may well reduce their assumed level of average interest, which could result in future pressure on the overall revenue budget.

3.27 The proportion of the Council's spending on debt is rising, although it remains at affordable levels. With the vast majority of capital spending covered through government grant or revenue support, the increases largely represent increased approval from government to spend capital resources. The HRA figures supported include the Homes Pride programme, funded entirely by increased Housing Revenue Account Subsidy through the ALMO element of that formula. There is only a marginal impact on the HRA itself, and no impact at all on rents, which are being governed by government policy on rent restructuring.

Treasury Management

3.28 The Treasury Management Strategy is set out in Appendix 2 to this report. The basic strategy is consistent with the approach adopted in previous years. The changes are mainly as a result of the Local Government Act 2003, and new guidance from the government that requires Authorities to adopt an Annual Investment Strategy. The Treasury Management Strategy incorporates the Annual Investment Strategy.

3.29 The Council adopted the CIPFA Code of Practice for Treasury Management from April 2002. In the Prudential Code this is recognised as a prudential indicator.

3.30 The other prudential indicators that are 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. These indicators are a formalisation of existing practice and are expected to be the same for the years 2004/05 to 2006/07.

3.31 The formal indicator in the prudential code relates to the net exposure to interest rates. The suggested indicator is:

	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. For clarity, it is proposed to supplement the official indicator with separate local indicators for long term borrowing and investments . The suggested local indicators are shown below:

	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

These indicators express the policy clearly – that no more than 20% of longer term borrowing will be taken at a variable rate.

3.32 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	5
> 5 years and <10 years	50	10
> 10 years	80	50

Short-term borrowing has been excluded from the above figures

3.33 These indicators indicate that the plan is to spread the balance of the future maturity of loans as far as possible.

3.34 The Prudential Code also requires a planned limit on investments made over one year in length. Currently the Council makes no such investments, but the changed legislative position means that should it become advantageous to do so, such an investment could be made. The Prudential Code requires that the Council should set an upper limit on such investments. It is suggested that this limit should be an overall limit of £15m 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.

3.35 No policy can prevent all risks, but the overall balance of the Treasury Management strategy and these indicators gives the Council enough flexibility to manage its day-to-day operations, while setting reasonable limits on the overall balance of risks that are taken.

OTHER OPTIONS CONSIDERED

4. The indicators are largely technical in nature, but some do allow a degree of choice. The maturity structure and interest rate exposure balance and the affordability of additional borrowing are the key decisions where different levels could be set, as long as these were consistent with other decisions of the Council.

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Background papers:	Local Government Act 2003, LGA summary of Local Government Act 2003, CIPFA Prudential Code for Capital, CIPFA code of practice for Treasury Management
List of appendices:	Appendix 1 – Implications Appendix 2 – Treasury Management Strategy 2004/5 Appendix 3 – Summary of Prudential Indicators

IMPLICATIONS

Financial

1. Set out throughout 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

Corporate Themes and Priorities

4. Value for Money is promoted through the continuation of sound treasury management policy, and a limited amount of unsupported borrowing.

APPENDIX 2

TREASURY MANAGEMENT STRATEGY 2004/05

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. The main difference from previous years is to take account of the Prudential Code, which comes into effect on 1 April 2004, following the recent Local Government Act 2003, LGA 2003. In addition, the requirements of the draft ODPM guidance on Local Government Investments have been considered in drawing up the strategy.

1.2 Allocation of Local Government supported capital expenditure, called SCE(R), were announced recently and have been reflected in the separate report on this agenda, “Capital Budget 2004/05 to 2006/07”. These allocations, together with unsupported borrowing of £2 million and maturing loans from previous years result in a potential financing requirement for 2004/05 of £38.8m. This requirement can be met by borrowing from external sources or internally generated funds. The precise market position will, as usual, be taken into account to determine this. In addition, the Council is continually seeking advice to identify restructuring opportunities in pursuit of debt cost savings.

1.3 The draft investment guidance referred to in 1.1 requires local authorities, as part of an 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.

1.4 In February 2004, investment rates were forecast by our treasury advisers to rise gently to 4.25% by the end of 2004, with a possible further increase to 4.5% by June 2005. The general strategy toward investments is to undertake either short or long dated investments that outperform market expectations, informed by our treasury advisers. Market rates will move during 2004/05 and the implications of the strategy will impact on investment periods accordingly.

1.5 Performance on both borrowing and investments during 2003/04 compared favourably with actual market movements. PWLB borrowing was taken towards the lower end of rates available during the year, actual borrowing averaging 4.70% against an average 25 year PWLB rate of 4.96%. Returns on investments are expected to outperform the expected average Bank of England base rate of 3.70% for 2003/04.

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 LGA 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 (TMP's). Derby's TMP's were approved by the Cabinet 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 2004/05, which have been produced in consultation with its external treasury consultants.

3. BORROWING STRATEGY

3.1 In determining Derby's borrowing strategy for 2004/05, account has been take of:

- the latest regulatory framework - LGA 2003
- the existing borrowing structure
- potential borrowing requirement for the year, including ALMO loans
- sources of new borrowing
- external factors influencing borrowing decisions, for example interest rate movement.

3.2 Regulatory Framework

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

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

- the Council's TMP's as mentioned above

- the Council's planned borrowing limit, described as its Capital Financing Requirement (CFR), and determined in accordance with the Prudential Code. Section 3.12 of this report describes the CFR, together with other operational boundaries required by the code in more detail and are summarised below.

	CFR	Operational Boundary	Authorised Limit
	£m	£m	£m
2003/04	283.4	-	-
2004/05	317.3	350.0	400.0
2005/06	344.1	380.0	430.0
2006/07	360.9	400.0	450.0

3.3 Existing Borrowing Structure

As at 31 March 2004, it is expected that the Council will have external debt amounting to £269.7m against an expected capital financing requirement for the same date of £283.3m. This consists primarily of loans from the Public Works Loan Board (£194.0m) at a weighted average interest rate of 5.52% together with market loans of £22.7m taken as Lenders option, Borrowers option (LOBO) loans, plus net debt transferred from the County Council in 1997 of £49.3m. All PWLB loans are currently at fixed rates, with the LOBO loans running at a very low (0.75%) rate until June 2005, increasing to the higher of 4.45% or the prevailing market rate thereafter. As prevailing PWLB rates have moved upwards since the LOBO loans were taken, the Council is likely to have gained from this arrangement.

2003/04 borrowings, taking into account the £6m accelerated Derby Homes capital programme, are expected to total £43.7m, having been taken at a weighted average rate of 2.65%. This low average takes into account that LOBO loans were taken at 0.75% for their first 2 years.

The prudential code requires the formalisation of an indicator detailing net exposure to interest rates which is its borrowing net of investments. The proposed indicator is 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, it is proposed to supplement the official indicator with separate local indicators for long term borrowing. The suggested 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.

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, has been set for the Council for 2004/05:

	Upper Limit %	Lower Limit %
Under 1 year	15	0
> 1 year and < 2 years	15	0
> 2 years and < 5 years	30	5
> 5 years and < 10 years	50	10
> 10 years	80	50

This structure will ensure a smooth loan maturity profile is maintained, thus reducing the Council's exposure to high interest rates when refinancing.

3.4 2004/05 Borrowing Requirement

The amount the authority expects to borrow in 2004/05 to fund planned and previous capital expenditure is £38.8m. This has been calculated as follows:

	£m
2003/04 borrowing not taken	1.3
New borrowing using central government Supported Capital Expenditure (SCE)R allocations for 2004/05 (including £24.9m SCA funding for ALMO expenditure)	35.4
Unsupported Borrowing	2.0
Long Term loan repayments 2004/05	0.1
Potential borrowing requirement 2004/05	38.8
Of which, relates to previous years capital financing	1.4
Less: earmarked for repayment of debt	3.4
Net increase in expected debt (CFR)	34.0

3.5 Sources of Borrowing

The authority can meet its financing requirement in one or a combination of two ways. It can borrow from external sources and/or use funds generated internally.

If the authority chooses to borrow externally, it can use either the money market or the Public Works Loans Board (PWLB). Historically, PWLB loan interest rates have been lower than other forms of long-term borrowing, and the authority has therefore tended to borrow from this source. However, opportunities arose during 2003/04 to borrow from the market at advantageous rates, reflected in the Council's decision to borrow £22.7m in the form of LOBO loans, essentially to finance the ALMO expenditure programme for the year. Following the introduction of the prudential code, the PWLB no longer operate a borrowing quota system, but the authority is governed by the code's requirement to remain within its CFR and authorised limits.

From 2004/05, funds created internally have only one primary source. This is the amount the authority must set aside from the revenue account to meet debt liabilities, known as the minimum revenue provision (MRP). The timing of the use of these funds is left for the authority to manage. Previously, a percentage of housing capital receipts was set aside to repay debt and could also be used to fund capital expenditure. This element must, from 1 April 2004, be paid direct to the government in the year it is received. The useable portion of housing right to buy capital receipts remains at 25% and continues to be available to support capital investment. Subject to meeting certain conditions, the useable portion of other housing capital receipts should be 100%.

3.6 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) and have made the following observation:

- "long term PWLB rates have fluctuated between 4.40% and 5.10% in 2003/04. Borrowing has been timed carefully during the year and the Council has borrowed the majority of loans at the lower end of the spectrum, rates averaging 4.70%. Long term PWLB rates are forecast to be constant at 5% for the whole of 2004/05."

Current advice from our advisers is that long dated PWLB debt and variable rate debt offers the best value for borrowing, and that commitment to medium dated debt should be avoided. However, any substantive reliance on variable debt will leave the Council exposed to market fluctuations, and does not therefore minimise risk. With the exception of LOBO loans, where the Council can limit the extent of variability, variable debt has been avoided, and it is planned to continue this policy. For similar reasons, there is also a need to achieve a debt maturity profile that reduces exposure to market changes in any one year. Recommended limits are that no more than 15% of the debt portfolio should mature in any one year, which limits the use of short dated borrowing.

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

The need for variable rate debt is also questionable, whilst the Council retains significant surplus cash balances, much of which is invested at what are in effect variable rates due to the very short period of the investment. The strategy for 2004/5 will consider the option of running down cash balances significantly over the year, the extent of which will depend on the value considered to be available from long and medium dated borrowing. In so far as this is an option, it will also provide flexibility over the timing of external borrowing when prevailing market rates are considered to be particularly low.

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

Options are available to the Council to reschedule further long term loans in 2004/05 which may be running at disadvantageous interest rates, or where savings can be made to reduce the debt charge costs to the authority. Derby's external treasury advisors will continue to provide rescheduling forecast models to determine the financial implications of repaying and/or replacing specific loans, which may be acted upon under delegated powers.

The Council may also, under delegate powers, enter into further LOBO loans should market conditions appear advantageous, but such loans will be treated as variable under the overall borrowing limits set by the Council, and risks will therefore be limited. It should also be noted that if LOBOs are used in a debt restructuring to replace existing short dated loans of similar length to the fixed period in the LOBO, there is no additional exposure to short dated volatility from use of the LOBO.

4. INVESTMENT STRATEGY

4.1 The Council, in devising its annual investment strategy, must have regard to the guidance on Local Government Investments recently issued by the Office of the Deputy Prime Minister (ODPM), although at the time of this report, that guidance was still in draft form. The guidance, which is intended will replace the existing approved investment regulations set out in the Local Government and Housing Act 1989, comes 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 expected requirements of the latest ODPM guidance, once issued.

ODPM draft 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.

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 it. Base rates have remained low during 2003/04, ranging between 3.5% and 3.75%, prior to 5 February, when the base rate was raised to 4.0%. During this period however, the Council expects to have secured an average return on external investments significantly in excess of the average base rate. Our advisers predict that the base rate, which currently stands at 4.0%, will rise to 4.25% by the end of 2004, with a possible further 0.25% rise by March 2005.

4.3 The Council ability to secure this good rate of return has depended on its ability to act flexibly when market conditions suggest a particular investment is good value. The general strategy is therefore to take either short or long dated investments that outperform market expectations, informed by the view of our treasury advisers. Market expectations will move during 2004/05 and the implications of this strategy will impact on investment periods accordingly.

4.4 Short-term cash surpluses, which have fluctuated between £45 million and £75 million during 2003/04, have 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 will reflect these levels in 2004/05, provided that there are no decisions to borrow internally to fund capital expenditure. The borrowing requirement has reduced in 2004/05 from 2003/04, primarily due to the fact that some capital allocations, previously financed through supported capital borrowing, are now being financed from central government grant.

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

4.6 The latest ODPM guidance, once approved, will allow greater flexibility in which investment facilities can be used. However, the 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, and following advice from the Council's treasury advisers, it is recommended that a maximum of £15m of the Council's portfolio 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 draft 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 will be subject to the same lending limits and counterparty restrictions as Specified Investments (Annex 1).

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

4.8 The Authority's lending list for specified and non-specified investments will be continually reviewed during 2004/05 to ensure 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 it is proposed to set specifically for the council's lending for 2004/05:

	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 current brokers/direct counterparties used for money market deals are as follows:

Brokers:

- Garban Intercapital
- London Currency Brokers
- Tradition UK
- Sterling
- Prebon Marshall Yamane

Direct Counterparties

- Abbey
- Bank of Scotland
- Britannia Building Society
- Co-operative Bank (overnight investments)
- Halifax Bank of Scotland (HBOS)
- Lloyds TSB

The above range of brokers and direct dealing counterparties is considered sufficient to ensure that the objectivity of dealings is maintained. No additions are therefore intended at this time.

ANNEX 1

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.

It is proposed to base the selection of organisations on the Fitch credit rating service, subscribed to by our treasury management consultants and widely used by many local authorities.

CATEGORY 1
UK CLEARING BANKS AND MAIN BANKS AND THEIR WHOLLY OWNED SUBSIDIARIES

(a)	Those with a short-term rating of F1+ and an individual rating of A or B, and a legal rating of 3 or above	up to £15 million
(b)	Those with a short-term rating of F1 and an individual rating of A or B, and a legal rating of 4 or above	up to £10 million

Maximum exposure of 3 months for subsidiaries. The Banking Sector (including Foreign Banks) is limited to an overall 70% with no one institution having more than 25% of the total.

CATEGORY 2
BUILDING SOCIETIES

(a)	Nationwide Building Society (ranked no.1)	up to £10 million
(b)	Other top 10 Building Societies	up to £6 million
(c)	Those top 20 Building Societies with a short-term rating of F1+, a legal rating of 3 or above and an individual rating of A or B	up to £6 million
(d)	Other top 20 Building Societies with assets over £500 million	up to £3 million

Sector limit of 60% of the total investment portfolio at the date of investment.

CATEGORY 3
FOREIGN BANKS (suggested by Treasury Management advisors based on robust economies and sound banking systems)

(a) long term rating of AA and above, and

(b) those with a short term rating of F1+, and an individual rating Of A or B, and a legal rating of 2 or better

Maximum of £10 million with each bank. The Banking Sector (including UK Clearing Banks) is limited to an overall 70% with no one institution having more than 25% of the total.

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:

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

CATEGORY 4
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

Debt Management Account (DMA) Facility

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

ANNEX 2

NON-SPECIFIED INVESTMENTS

POTENTIAL INVESTMENT OPTIONS & ASSOCIATED RISK

The maximum limit for non-specified investments at any one time is ***£15m*** 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 draft guidance, are not currently considered suitable, and are being 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

Prudential Code indicators **APPENDIX 3**
Summary

Prudential Code Reference	Report Reference	Item	Actual 2002/3	Estimated: 2003/4	2004/5	2005/6	2006/7
Affordability							
35 - 36	3.22	**Forecast Financing cost to Net Revenue Stream Ratio**					
		- General Fund %		4.31	4.46	4.42	4.53
		- HRA %		22.71	19.72	22.41	23.28
37-38	3.23	**Actual Financing cost to Net Revenue Stream Ratio**					
		- General Fund %	4.09				
		- HRA %	23.37				
39	3.24	**Impact on Council Tax - Band D £/year - £2m a year plan**			0.75	3.45	6.15
39	3.24	**Incremental Impact on Council Tax - Band D £/year per £m**			0.38	1.73	3.08
40-41	3.19	Incremental Impact on Housing Rents £/week			0.00	0.00	0.00
Prudence							
45	3.17	**Actual / Forecast Borrowing compared to CFR**					
		- External Debt excluding Transferred Debt £m	183.1	216.7	253.5	284.3	297.4
		- CFR £m		283.4	317.3	344.1	360.9
Local	3.17	- External Debt including Transferred Debt £m		269.7	304.4	333.3	344.5
		- CFR £m		283.4	317.3	344.1	360.9
Capital Expenditure							
51-52	3.10	**Total Capital Expenditure**					
		- General Fund £m			34.0	30.7	34.3
		- HRA £m			33.5	27.4	8.3
		- Total £m			67.5	58.1	42.6
53-54	3.12	**Estimated Capital Financing Requirement**					
		- General Fund £m		161.5	169.6	176.7	192.7
		- HRA £m		121.9	147.7	167.4	168.2
		- Total £m		283.4	317.3	344.1	360.9
57-58		Actual CFR		Not yet applicable			
External Debt							
59	3.16	Authorised Limit for borrowing £m			400	430	450
		Authorised Limit for other long term liabilities £m			1	1	1
		Authorised Limit £m			401	431	451
60	3.16	Operational Boundary for borrowing £m			350	380	400
		Operational Boundary for other long term liabilities £m			1	1	1
		Operational Boundary £m			351	381	401
Treasury Management							
66	3.29	**Adopted CIPFA Treasury Management Code of Practice**	Yes	Yes	Yes	Yes	Yes
67-70	3.31	**Interest Rate Exposure - Fixed**					
		Upper limit %			120	120	120
		Lower limit %			80	80	80
67-70	3.31	**Interest Rate Exposure - Variable**					
		Upper limit %			20	20	20
		Lower limit %			-20	-20	-20
Local	3.31	**Long term Borrowing - Fixed rate**					
		Upper limit %			100	100	100
		Lower limit %			80	80	80
Local	3.31	**Long term Borrowing - Variable rate**					
		Upper limit %			20	20	20
		Lower limit %			0	0	0
Local	3.31	**Investments - Fixed rate**					
		Upper limit %			100	100	100
		Lower limit %			30	30	30
Local	3.31	**Investments - Variable rate**					
		Upper limit %			70	70	70
		Lower limit %			0	0	0
74	3.31	**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		5	
		Between 5 and 10 years		50		10	
		Over 10 years		80		50	
77	3.32	**Investments over a year - limit £m**			£15m		
		Additionally, no investment to be longer than three years from date of investment					