

REPORT TO:	FINANCE AND MANAGEMENT COMMITTEE	AGENDA ITEM:
DATE OF MEETING:	29th APRIL 2004	CATEGORY:
REPORT FROM:	CHIEF FINANCE OFFICER	RECOMMENDED
MEMBERS' CONTACT POINT:	KEVIN STACKHOUSE (595811)	OPEN
SUBJECT:	TREASURY MANAGEMENT STRATEGY 2004/05	DOC: u/ks/treasury management/strategy200405
WARD(S) AFFECTED:	ALL	REF:
		TERMS OF REFERENCE: FM08

1.0 Recommendations

- 1.1 That the Council manages its cash flow requirements through short-term borrowings and bank deposits.
- 1.2 That no longer-term borrowing for 2004/05 is undertaken.
- 1.3 That the Money Market loan of £1m be repaid should the Lender invoke their option to increase the Interest Rate.
- 1.4 That the proposed revisions to the Council's Prudential Indicators as set out in Section 3.37 are approved.
- 1.5 That the investment strategy for 2004/05 as set out in **Appendix 3** is approved.
- 1.6 That the Council's revised lending list and associated commentary as detailed in Section 3.51 is approved.

2.0 Purpose of Report

- 2.1 To detail the proposed annual borrowing and investment strategies for 2004/05 in accordance with the Local Government Acct 2003 and associated regulations. This includes details of budgeted and actual interest for 2003/04 and 2004/05. In addition, the Council's Prudential Indicators are reviewed in the light of the recent repayment of Government debt.
- 2.2 The report also details new regulations under the Local Government Act 2003, covering a new requirement for the Council to produce an annual investment strategy.

3.0 Detail

Background

- 3.1 Over the last 2 to 3 years, the Council has not been required to enter into any form of borrowing. This was due to substantial capital receipts that the Council had generated, a significant proportion of which had been set-aside to repay debt.
- 3.2 This was placed on bank deposit and earned interest for the Council's revenue fund. These receipts were effectively used to finance new capital expenditure in the form of Government credit approvals and to meet the Council's shorter-term cash flow requirements when these were negative.

Debt Repayment

- 3.3 Members will be aware that the Council agreed to repay all of its outstanding debt with the Government's Public Works Loan Board in February 2004. This was done using the set-aside receipts on deposit. The actual transactions took place on 5th March 2004, when it was considered that long-term interest rates that determine the value of the penalty payment were at their most favourable.
- 3.4 The total amount repaid to the PWLB with a comparison to that estimated is set out in the following table.

Amount Repaid to PWLB	Estimated £	Actual £
Principal	7,999,346	7,999,346
Penalty Payment	2,538,447	2,418,791
Total	10,537,793	10,418,137

- 3.5 The above payment was generally in line with that anticipated. The reduction in the penalty payment of around £120,000 effectively means that the Council maintains set-aside receipts over and above that estimated. However, there is no direct impact on the Council's revenue account.
- 3.6 In addition, the Council, by repaying before the end of the financial year, has saved approximately 1 months interest compared to that budgeted in 2003/04 of **approximately £40,000**. These are additional savings on top of that reported in February.

Debt Remaining

- 3.7 The only remaining debt now outstanding is one money market loan for £1m. This is a fixed loan at 4.875%, maturing in 2032 with interest of approximately £48,000 per year

Bank Deposits

- 3.8 These had peaked at around £14m during 2003/04, but the balance of around £11m on 5th March was effectively used to make the debt repayment. The Council had been accruing significant interest on these deposits during the year and an amount of **£325,000** was included in the probable out-turn for 2003/04.
- 3.9 The actual amount earned for the year was **£324,333**, a very slight reduction, although the estimate had assumed a significant level of deposits for a full year. Clearly, the repayment of debt effectively shaved a month's potential interest off the calculation, although the saving in PWLB interest (3.6 above) significantly outweighs this.

BORROWING STRATEGY 2004/05

Prudential Borrowing

- 3.10 Members will also be aware that the new Prudential System for Capital Finance has freed many of the borrowing restrictions previously placed upon local authorities. Effectively, councils can now borrow money as long as they demonstrate that the associated interest and principal repayments are affordable and sustainable within their longer-term financial resources.
- 3.11 When the Council set its medium term financial projection for 2004 to 2007, it did not include any provision for prudential borrowing. This is a financing option that can be considered in the future and will be fed directly into the Council's financial planning process as appropriate.
- 3.12 The Government's general support for the Council's capital investment during 2004/05 is still in the form of a borrowing approval (£1/2m). From 2005/06, it is expected that any Government support will be in the form of capital grants.
- 3.13 In the light of the above, it is considered that the Council's borrowing strategy for 2004/05 should be based on the following.
- Meeting the Council's cash flow requirements
 - Reviewing options for the outstanding money market loan
 - Reviewing the Prudential Indicators as approved by Council on 26th February 2004
- 3.14 However, before analysing this, it is worth considering the outlook for interest rates as this will have a bearing on any strategy and costing projections.

Outlook for Interest Rates

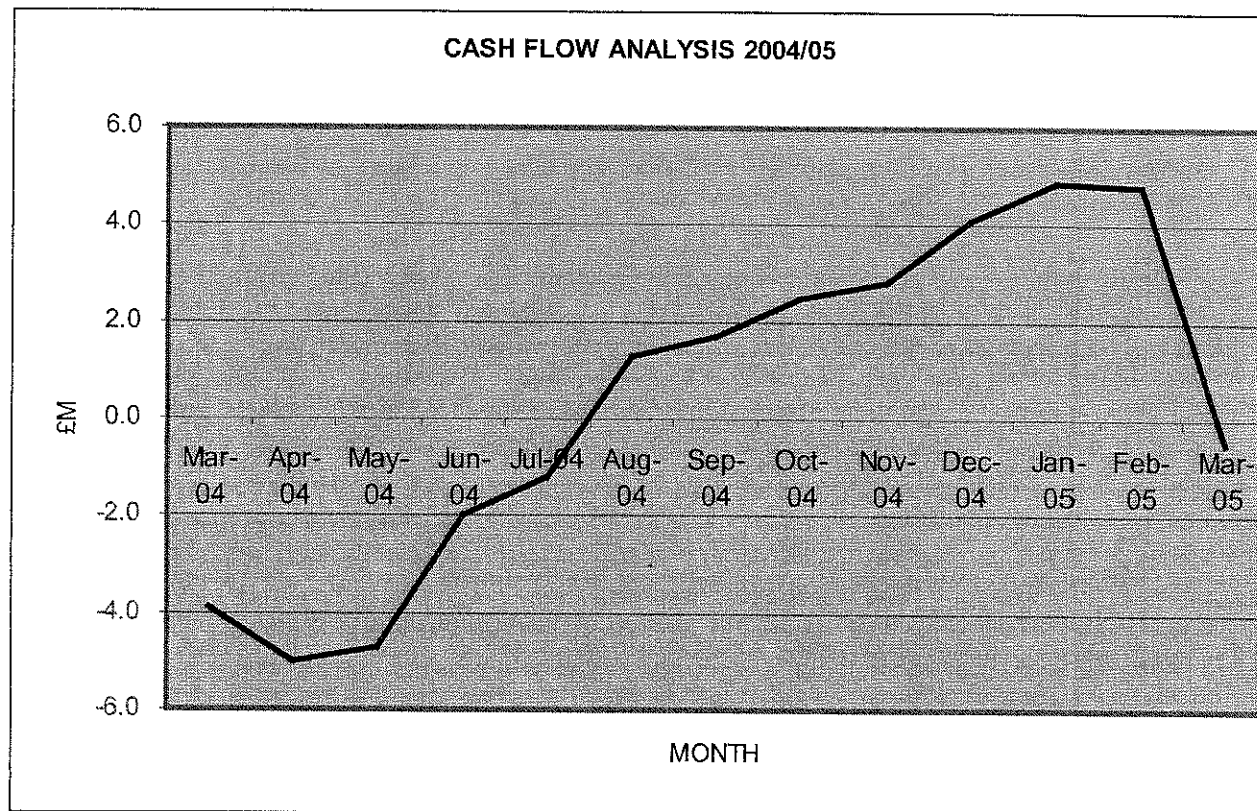
- 3.15 The Base Rate has been steadily increasing since September 2003 and the latest rise in February 2004 took the headline rate to 4%. This has been in line with the predictions of many commentators, who are continuing to predict further rises during 2004, with an expected rate of 5% by early 2005.
- 3.16 Beyond this, many economists are predicting lower rates again in the longer-term, especially if the United Kingdom adopts the Euro. Although predicting interest rates is never certain, it is anticipated that there will be no major fluctuations from current projections.
- 3.17 On this basis, the following changes in the Base Rate have been built into the Council's projections
- April 2004 – to 4.25%
 - July 2004 – to 4.50%
 - October 2004 – to 4.75%
 - January 2005 – to 5.00%

The Council's Cash Flow

- 3.18 The Council's cash flow on a daily basis can fluctuate depending on the timing of income and expenditure. At certain times of the year, the Council may need to

borrow to cover shortfalls on a temporary basis, whilst when cash flow is positive, any surplus funds are invested on a temporary basis.

- 3.19 The surplus funds that the Council had built up prior to debt repayment was in fact masking that at certain times of the year, the Council does have an overall temporary borrowing requirement. This is reflected in the cash flow model for 2004/05 that **forecasts** the following profile.



- 3.20 The above graph shows that the Council ends 2003/04 with temporary borrowings. Generally, the Council is a net borrower during the early part of the financial year, but is a net lender from July onwards. The maximum borrowing requirement will peak at £5.5m during April. It is anticipated that the Council's surplus funds will peak at around £7m in both December and February.
- 3.21 The cash flow model is based on both known and estimated cash flows. Known cash flows include precept payments and Government Grant receipts, which are agreed in advance of the year. Estimated figures include the timing of creditor payments, council tax and capital receipts, etc. and these are based mainly on historical patterns.
- 3.22 Based on the overall cash flow profile, it is unlikely that the Council will need to commit to any longer-term borrowing during 2004/05. However, this will be kept under review as usual, and cash flow managed on a daily basis in accordance with the Council's Treasury Management Policy (TMP 8)

* Budgetary Implications

3.23 The report on debt repayment reported the following savings.

Change to Base Budget	2004/05 £'000	2005/06 £'000	2006/07 £'000
Savings on debt interest to PWLB	624	615	606
Loss of Housing Subsidy	-48	-48	-48
Loss of Deposit Interest (as budgeted)	-450	-400	-350
Overall Savings	-126	-167	-208

3.24 The report also indicated that the loss of deposit interest may not be as great, as some money would still be maintained on deposit, although it would not increase to 2003/04 levels due to the "Pooling" of future capital receipts. In addition, it assumed that depending on the Council's overall cash flow, short-term borrowing would need to be undertaken at certain times during the year incurring interest payments.

3.25 The report assumed the loss of all deposit interest at that stage to maintain a provision to cover this eventuality. The above cash flow forecast is substantially different to that used for estimating figures for the current financial planning period 2004 to 2007, due to the debt repayment.

3.26 This report has already highlighted above the need for temporary borrowing at certain times of the year. However, it is estimated that the Council will still be a net gainer overall, as summarised below.

Estimated 2004/05 Revised Cash Flow Interest	£
Estimated Interest on Bank Deposits	77,000
Less – estimated payments on temporary borrowings	38,000
Estimated Net Interest Due to the Council	39,000

3.27 The estimated interest has been calculated based on the cash profile in **3.19** above, and projection of base rate changes in **3.17** above. This shows that an additional £39,000 should be generated in 2004/05 compared to that included in the current 3-year general fund financial projection.

Options for Remaining Debt

3.28 As highlighted in 3.7, the only long-term debt now remaining is one money market loan for £1m. Potentially, there is a break clause. The lender has the option of reviewing the interest rate at any time and increasing it if they so wish. However, the Council has the option of rejecting this and can instead choose to repay without incurring any penalty.

- 3.29 As interest rates are gradually rising, the lender may look to increase the rate, but this is by no means certain. If the lender did this, it may provide a suitable opportunity for the Council to repay, especially as it will generally have surplus funds in 2004/05 to do this.
- 3.30 Although effectively, the Council would need to cash in some of its remaining set-aside receipts, it would generate additional interest savings of around £48,000 per year to 2032. Any loss of deposit interest could be absorbed within savings highlighted elsewhere in this report.
- 3.31 The lender has been contacted about premature repayment of the loan. They are prepared to consider this, but have indicated a penalty payment of £150,000. On the basis of this, a calculation has been undertaken to ascertain whether in the longer-term, it would still be beneficial for the Council to do this. The calculation is set out in **Appendix 1**.
- 3.32 This shows that on a discounted cash flow basis, there would be a saving in a premature repayment, compared to retaining this loan, i.e. a payment of £1,150,000 now compared with total cash of £1,242,922 to service this loan over its remaining life.
- 3.33 The main risk is that the Council could get the opportunity to repay without a penalty over the next 12 months. This will depend on whether interest rates rise sufficiently high enough for the Lender to invoke their option. Therefore, it may be beneficial to keep this under review pending the Lender exercising this option. If this happens, it is recommended that the Council repaid the loan at that time.

Prudential Indicators

- 3.34 Members will be aware that a requirement of the Prudential Code of Practice is that the Council must set and regularly monitor Prudential Indicators. In addition, the Chief Finance Officer is required to provide an assessment of these indicators and the implications for the Council's spending plans and overall financial position.
- 3.35 The prudential system provides the flexibility for these indicators to be changed depending on local circumstances. It is the responsibility of the Chief Finance Officer to advise the Council accordingly, and the indicators can only be changed by Full Council.
- 3.36 These indicators need to be reviewed in the light of any significant debt repayment, or changes to the Council's overall borrowing strategy. The Indicators approved as part of budget setting for 2004/05, together with the associated commentary, are set out in **Appendix 2**.
- 3.37 In the light of the proposals discussed in this report, the following changes and comments to the current Indicators in Appendix 2 are proposed.

PI 1 – Capital Expenditure

No change required

PI 2 – Ratio of Financing Costs to Net Revenue Stream

The debt repayment will clearly reduce the amount of interest payable by the Council. Therefore, the Council's gearing is further reduced and the revised figures are shown below.

	2003/04	2004/05	2005/06	2006/07
General Fund	7.5%	3.5%	2.9%	2.4%
Housing Revenue Account	6.4%	3.6%	3.3%	3.1%

PI 3 – Capital Financing Requirement

No change required

PI 4 – Authorised Limit for External Debt

It is proposed that this be reduced by £8m from 2004/05 onwards to reflect the debt repayment. The proposed figures are therefore as follows.

- 2004/05 - £13.6m
- 2005/06 - £13.2m
- 2006/07 - £12.8m

PI 5 – Operational Boundary for External Debt

Again, it is proposed that this is down to a level of **£9m**. The Council's cash flow forecast predicts a peak in temporary borrowing of £5.5m. However, this will need to be kept under review. This amount should provide sufficient headroom, whilst providing an early indication of changes to borrowing patterns, if exceeded, before breaching the Authorised Limit above.

INVESTMENT STRATEGY

Local Government Investment Regulations

- 3.38 The Local Government Act 2003 now requires that the Council have a separate annual investment strategy. The Council does not have any long-term investments, but the regulations cover short-term investments such as the investment of surplus funds.
- 3.39 The Council currently invests those surplus funds in accordance with an approved lending list. This list is laid down in the Council's Treasury Management Policy (TMP 4) and is detailed in **Appendix 3**. This provides a good basis for conforming to the new regulations.
- 3.40 Guidance covering the new regulations states that

*"local authorities should invest **prudently** the surplus funds held on behalf of their communities. Priority should be given to security and liquidity. However, that does not mean that authorities should ignore yield. It will be appropriate to seek the highest rate of return consistent with the proper levels of security and liquidity."*

- 3.41 In addition, the Council is now required to distinguish between what are termed **specified** and **non-specified** investments.

Specified Investments

- 3.42 The idea of specified investments is to identify investments offering high security and high liquidity. These investments should be in sterling and with a maturity of no more than a year. They are designed to be used with minimal procedural formalities. Any investments made with the UK Government, a local authority or parish council automatically count as specified investments.
- 3.43 In addition, short-term investments with bodies or investment schemes with "**high credit ratings**" will count as specified investments. However, it is left to each authority to determine these institutions, and the Council must determine investment limits and how frequently these ratings are to be monitored.
- 3.44 The Council's current lending list broadly does this, through one of the 3 recognised credit rating agencies under the regulations, i.e. the "Fitch" IBCA Rating.

Non-Specified Investments

- 3.45 Basically, these are all other investments not meeting the above criteria. Due to the fact that these investments could carry more risk than specified ones, the Council needs to set limits on these investments and determine guidelines on when they should be used.
- 3.46 The regulations make it clear that they do not wish to discourage authorities from using non-specified investments. The aim is to ensure that proper procedures are in place for undertaking risk assessments of investments made for longer periods or with bodies that are not highly credit rated.
- 3.47 Based on these regulations, the following strategy is proposed. This is to meet the statutory requirements of the 2003 Act.

Investment Strategy 2004/05

- 3.48 As highlighted in the cash flow analysis earlier in this report, the Council will have a short-term investment requirement to enable it to manage its day to day financial affairs. There is no current proposal to enter into longer term and externally managed funds.
- 3.49 The current lending list and policy is up-to-date, is based on best practice and serves the short-term investment needs of the Council. In accordance with the new regulations, it sets out where the Council will invest surplus funds and places limits upon the various institutions.
- 3.50 In addition, it sets out guidance on restrictions such as placing money with non-British banks and institutions, i.e. a separate assessment and approval is required by the Finance Services Manager.
- 3.51 Therefore, it is proposed to use this as basis for 2004/05. To fully adopt the regulations there is a need to refine the current lending list, and to distinguish between specified and non-specified investments. The proposals are set out below.

Institution	Limit
Specified Investments	
• UK Debt Management Office (DMO)	£10m
• Local, Police, Fire and Parish Authorities	£5m
• Other Bodies with a High Credit Rating of F1+/AA-	£5m
Non-Specified Investments	
• F1/AA Rated Bodies – First Call	£1m
• F1/A Rated Bodies – Second Call	£0.5m
• F2/A Rated Bodies – Third Call	£0.25m

General Policy

- 3.52 It is proposed that priority be given to specified investments in any investment decision. This is in accordance with current practice and these institutions are usually the only ones used in any case. The length of investments can continue to be made in accordance with cash flow requirements, subject to the condition that they are for less than 1-year to meet the regulations.

DMO

- 3.53 It is proposed to continue to place the highest limit with the DMO as the Government guarantees investments, and it has the highest credit rating of any institution.

Local, Police, Fire and Parish Authorities

- 3.54 It is proposed to increase this limit from £1m to £5m to provide more flexibility of investment in this area. Returns are usually competitive and in line with market rates.

Other Bodies with a High Credit Rating

- 3.55 This generally covers UK banks and building societies. In accordance with best practice, the F1+/AA- credit rating is considered to be a high enough indicator for security and liquidity purposes. F1+ is the highest credit rating available for short-term deposits.
- 3.56 It is proposed to continue current practice in that before any investment is made, the relevant body is checked to ensure that it has this "Fitch" rating. Returns in this area have tended to be the most competitive.

Non-Specified Investments

- 3.57 This generally covers the merchant or secondary-banking sector. It is proposed that these are only used as a "lender of last resort" and in the order listed, although F1 and F2 credit ratings are still considered to be fairly high ratings for short-term deposits.

Performance Indicators

- 3.58 The main indicator is for the return on short-term investments to average **the Market 7-Day Rate**, which is a standard measure of performance in this area. This rate was **3.51%** for 2003/04. The actual rate achieved by the Council was slightly better than this at **3.55%**.

4.0 Financial Implications

- 4.1. These are considered as an integral part of the report.

5.0 Corporate Implications

- 5.1. As detailed in the report

6.0 Community Implications

- 6.1 As detailed in the report

7.0 Background Papers

- Finance and Management Committee 17th February 2004 – Agenda Item 9
- Local Government Investments – Regulations and Guidance Notes