REPORT TO:	**FINANCE AND MANAGEMENT COMMITTEE**	**AGENDA ITEM:**	11
DATE OF MEETING:	**15TH FEBRUARY 2005**	**CATEGORY: RECOMMENDED**	
REPORT FROM:	**DIRECTOR OF CORPORATE SERVICES**	**OPEN**	
MEMBERS' CONTACT POINT:	**KEVIN STACKHOUSE (595811)**	**DOC:** u/ks/treasury management/strategy200506	
SUBJECT:	**ANNUAL TREASURY MANAGEMENT STRATEGY 2005/06**	**REF:**	
WARD(S) AFFECTED:	**ALL**	**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 the Money Market loan of £1m be repaid should the Lender exercise their option to increase the Interest Rate.

1.3 That the Council invests surplus funds in accordance with the approved lending list and policy as detailed in **Appendix 1.**

2.0 Purpose of Report

2.1 To detail the proposed annual borrowing and investment strategies for 2005/06 in accordance with the Local Government Act 2003 and associated regulations.

3.0 Executive Summary

3.1 The Council is now benefiting from additional capital receipts due to its "debt free" status. These resources are currently being set-aside to repay any future debt and for future capital investment.

3.2 The receipts are being placed on deposit and are helping to ensure that the Council's overall cash flow remains positive. Besides generating interest, it is projected that the Council will not have a temporary borrowing requirement at anytime during 2005/06.

3.3 It is not proposed to change the Council's current policy or approved lending list governing investments, as it continues to meet the Council's requirements for managing day to day cash flow.

3.4 The only long-term (fixed rate) debt outstanding is 1 Money market loan. This will be kept under review with a proposal to repay it without penalty should the Lender exercise their option to increase the interest rate from it current level.

4.0 Detail

BORROWING STRATEGY 2005/06

4.1 Over the last 3 years, the Council has not been required to enter into any form of long-term borrowing. This was due to substantial capital receipts that the Council has generated, a significant proportion of which had been set-aside to repay debt.

4.2 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.

4.3 In addition, the Council repaid all of its long-term Government debt in March 2004 using accumulated set-aside receipts. This still left around £9m in the Council's set-aside provision at the draw down of 2003/04. This is expected to rise to around £9.5m by March 2005.

Debt Remaining

4.4 The only remaining fixed 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.

Prudential Borrowing

4.5 The 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.

4.6 The Council's current financial projections to 2008 do not include any provision for prudential borrowing. This is a financing option that can be considered in the future and can be fed directly into the Council's financial planning process as appropriate.

Government 's Borrowing Allocation

4.7 The Government's general support for the Council's capital investment during 2005/06 is still in the form of a borrowing approval (£615,000). However, given the amount of set-aside receipts, it is unlikely that the Council will need to borrow during 2005/06.

4.8 In the light of the above, it is considered that the Council's borrowing strategy for 2005/06 should be based on the following criteria:

- Meeting the Council's cash flow requirements, and
- Reviewing options for the outstanding money market loan.

Outlook for Interest Rates

4.9 Between April and August 2004, there were 3 increases in the Base Rate, which took it from 4% to 4.75% in line with many economic predictions. The rate has since remained unchanged for 5 months.

4.10 The Market is now convinced that 4.75% is the peak rate, although there is a small chance it could go higher towards the end of 2005 due to the escalating level of private debt. The main factor for setting interest rates is the underlying level of inflation.

4.11 As regards this, the economy is still growing and consumer spending and wages continue to rise. However, this is being offset by a steady fall in house prices and the easing price of oil. Clearly, predicting interest rates is never certain and world events or the performance of other economies can affect the outlook very quickly.

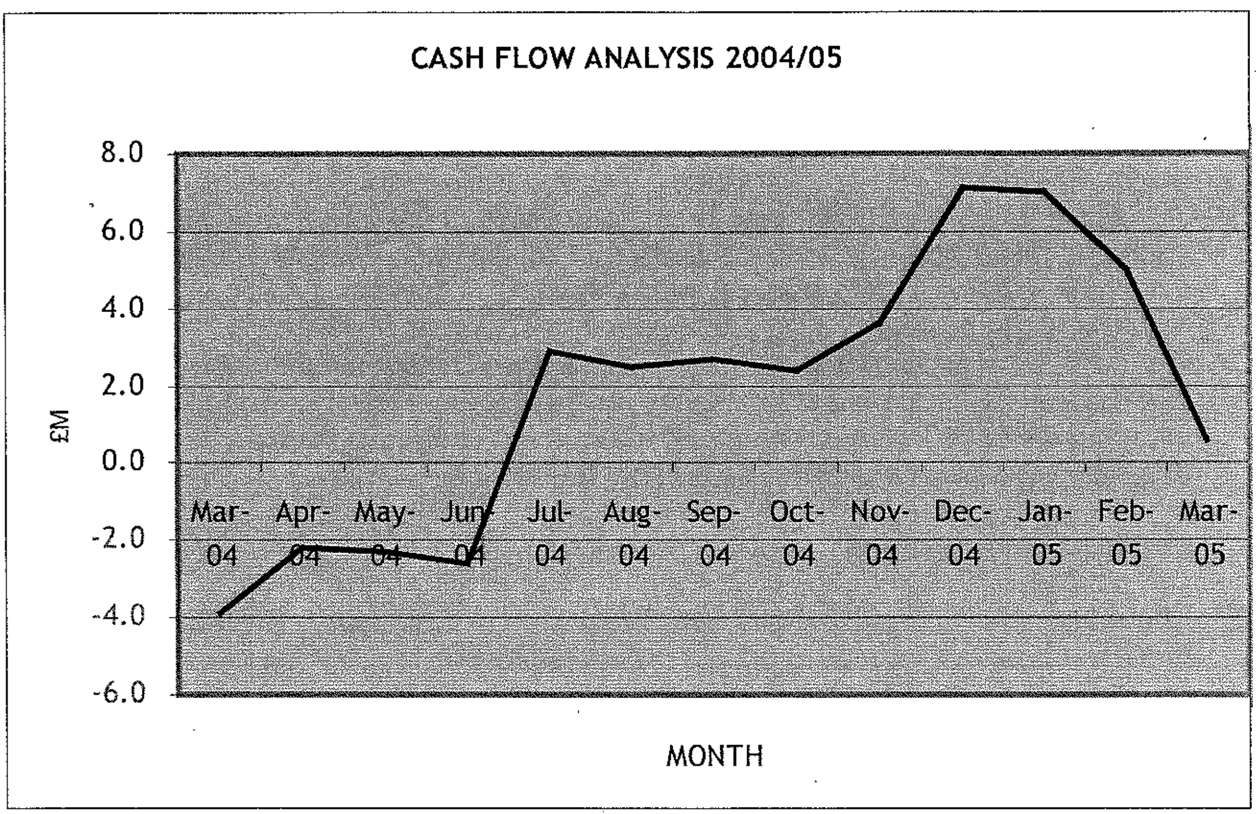
4.12 Having said this, interest rates are not considered to be a major risk to the Council as it does not currently have any significant long-term debt or a major borrowing requirement over the next year. Therefore, the Council is not effectively exposed to fluctuations in interest rates.

4.13 For the purposes of managing the Council's cash flow, a rate of 4.75% has been used in the projections

The Council's Cash Flow

4.14 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.

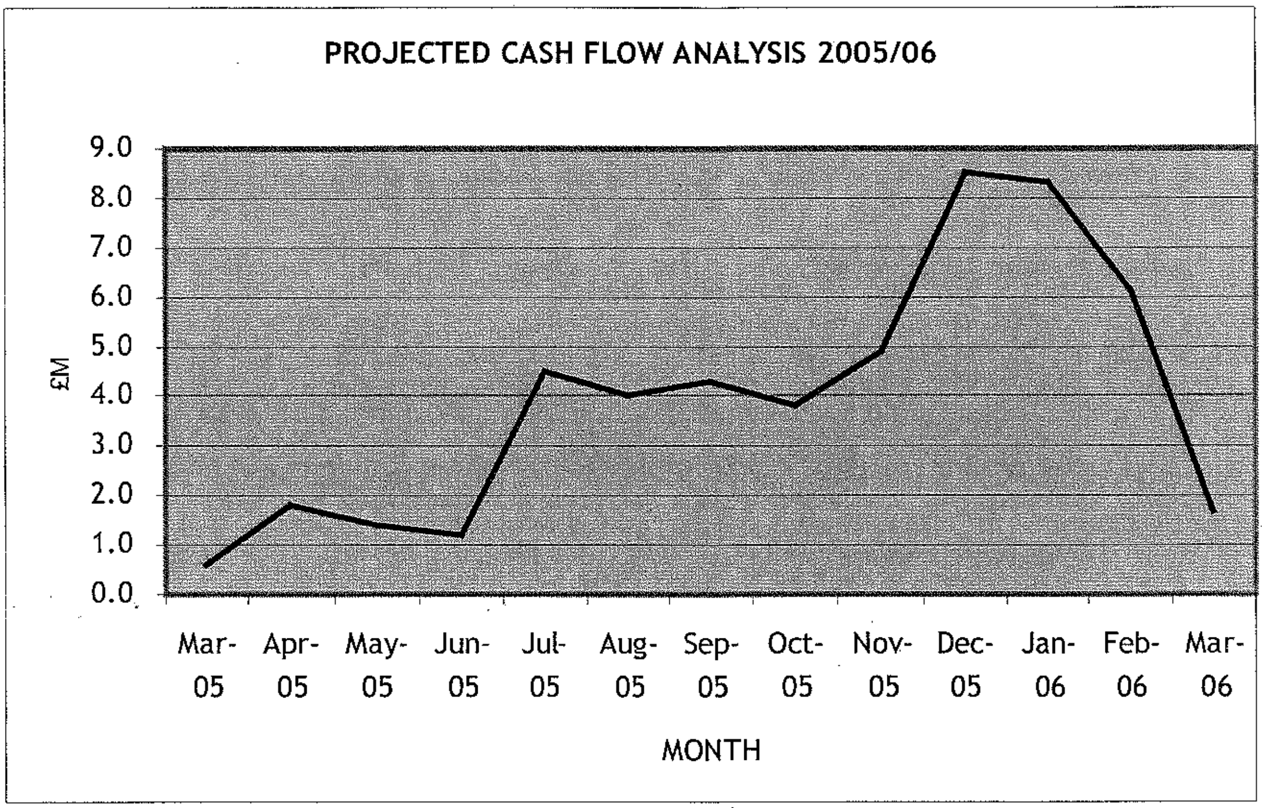
4.15 The Council continues to benefit from surplus funds due to asset sales, a proportion of which need to be set-aside for future debt repayment. The Council's cash flow over the 12 months to April 2005 is shown below.



4.16 The above graph shows that the Council entered 2004/05 with temporary borrowings. Generally, the Council is a net borrower during the early part of the financial year, but is a net lender after the first ¼ onwards. The maximum borrowing requirement peaked at around £2.6m during June 2004. Since this date, the Council 's cash flow has been in surplus, and this is currently projected to continue over the next year.

4.17 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.

4.18 The Council's cash flow is projected to have the following pattern during 2005/06.



4.19 The above profile shows that the Council is unlikely to need to borrow at all during 2005/06. This is largely due to the additional capital receipts that the Council is able to keep over the next 3 years by being "debt free."

4.20 Clearly, this will need to be kept under review, as it is unclear when and how much of these additional receipts will be spent over the coming year. The Council's cash flow will continue to be managed on a daily basis in accordance with the Council's Treasury Management Policy (Reference TMP 8).

Budgetary Implications

4.21 The above cash flow projections have been used in determining the level of interest that has been built into the Council's probable out-turn for 2004/05 and base budget for 2005/06. These figures are summarised below.

Cash Flow Interest	2004/05 £	2005/06 £
Estimated interest on bank deposits Less – Estimated payments on temporary borrowings	100,000 -25,000	130,000 -5,000
Estimated Net Interest Due to the Council	**-75,000**	**-125,000**

Options for the Remaining Money Market Debt

4.22 As highlighted in 4.4, the only long-term debt now remaining is one money market loan for £1m. This costs around £48,000 per year in interest charges at 4.875%

4.23 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.

4.24 In setting the borrowing strategy for 2004/05, it was resolved that it was not cost effective to prematurely repay this loan due the penalty payment involved. However, it was also resolved that should the lender exercise their option to increase the interest rate, then the loan should be repaid at that time.

4.25 As interest rates have not risen substantially over the last year, and the ultimate repayment period is still around 27 years, the situation regarding premature redemption has not changed. However, it is still recommended that should the lender invoke their option during 2005/06, then the loan should be repaid at that time.

4.26 It appears that this is unlikely unless rates rise substantially. However, s the cash flow forecasts indicate above, the Council should have sufficient set-aside capital receipts to enable this. This issue will be kept under review.

INVESTMENT STRATEGY 2005/06

Local Government Investment Regulations

4.27 The Council does not have any long-term investments, but these regulations cover short-term investments such as the deposit of surplus funds. The Council invests surplus funds in accordance with an approved lending list.

4.28 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."

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

Specified Investments

4.30 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.

4.31 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.

4.32 The Council's approved lending list covers this, through one of the 3 recognised credit rating agencies under the regulations, i.e. the "Fitch" IBCA Rating.

Non-Specified Investments

4.33 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.

4.34 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.

4.35 Based on these regulations, the following strategy is proposed. This is to meet the statutory requirements of the 2003 Act.

Proposed Investment Strategy 2005/06

4.36 As highlighted in the cash flow analysis earlier in the 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.

4.37 The current approved list is based on best practice and is serving the short-term investment needs of the Council. It is considered that there is no compelling reason why the list and associated limits should be changed, although it is kept under review.

4.38 The approved lending list and policy is shown at **Appendix 1** for information. In accordance with regulations, it sets out where the Council will invest surplus funds and places limits upon the various institutions. A summary is shown 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

4.39 As approved, priority is 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 are made in accordance with overall cash flow requirements, subject to the condition that they are for less than 1-year to meet the regulations.

Use of Non-Specified Investments

4.40 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 in the table in 4.37. It should be noted that F1 and F2 credit ratings are still considered to be fairly high ratings for short-term deposits.

Performance Indicators

4.41 The main indicator is for the return on short-term investments to, **average over the year, the Market 7-Day Rate.** This is a standard measure of performance and is a rolling annualised rate for which performance against this rate is best measured taking into account a full year's investment returns.

4.42 This due to the fact that the level of Council investments is skewed over the year. As discussed in the cash flow analysis, surplus funds tend to be more limited during the early part of the financial year and are invested for as little as 1 or 2 days. These attract interest rates at the lower end of the scale.

4.43 As the year progresses, deposits tend to be higher and for longer periods. These attract higher than average rates.

4.44 The last full year was 2003/04 for which the average market rate was **3.51%.** The actual rate achieved by the Council was slightly better than this at **3.55%** (as reported in April 2004).

5.0 Financial Implications

5.1 These are considered as an integral part of the report.

6.0 Corporate Implications

6.1. None directly

7.0 Community Implications

7.1 None Directly

8.0 Background Papers

- Finance and Management Committee 29th April 2004
- Local Government Act 2003 – Associated Regulations and Guidance Notes