Cabinet – 9 February 2005

Annual treasury management and investment strategy - prudential indicators 2005/06 onwards

Portfolio: Councillor John O'Hare – Deputy Leader

Service Area: Corporate finance

Wards: All

Forward Plan: Yes

Summary of report

This report sets out treasury management and investment strategies as required by the CIPFA Code of Practice and the council's investment and treasury management policy statement for 2005/06 onwards (**Appendices 1 and 2**). It also provides details on the Prudential Code Indicators (PCI's) for the next three years (**Section 4.8 & Appendix 3**) and asks Cabinet to recommend adoption of these to full Council. The report both complies with the Local Government Act 2003 and also proposes an additional framework over and above the statutory minimum for monitoring performance in line with the council's performance management and improvement agenda.

Recommendations

1. That the 2005/06 treasury management strategy document set out in **Appendix 1,** the 2005/06 investment strategy document set out in **Appendix 2** and the adoption of the Prudential Indicators set out in **section 4.9 and in Appendix 3** be approved and recommended to Council.
2. That decisions to effect movements between conventional borrowing and other long term liabilities, such as leases, be delegated to the Executive Director (Chief Finance Officer).
3. That decisions to use capital receipts or unsupported borrowing within the framework of approved prudential indicators be delegated to the Executive Director (Chief Finance Officer).

Resource and legal considerations

The council is expected to end 2004/05 with loan debt of £195m and short term investments of between £50m and £60m. These need to be proactively managed to minimise borrowing costs and maximise investment returns within a robust risk management environment. In 2005/06 estimated annual interest payments are c £8.2m and investment interest income c £1.9m.

Citizen impact

None directly related to the report.

Community safety

None directly related to the report.

Environmental impact

None directly related to the report.

Performance and risk management issues

Treasury management activity must take place within a robust risk management environment, which enables the council to effectively maximise investment income and minimise interest payments without undue or inappropriate exposure to financial risk. A risk assessment has been undertaken in determining the 2005/06 policy and this is contained within the council's corporate risk register.

The ability to contain costs and make savings in this activity directly impacts on the level of resources available for the development of council strategies. Treasury management activity is delegated to the Assistant Director of Finance and Head of Corporate and Strategic Finance. Relevant activities take place within the framework of the council's treasury policy statement, which sets out the type of activities that may be undertaken and by whom. It also specifies formal reporting requirements.

Equality implications

None directly relating to this report.

Consultation

The strategies have been approved by the Finance Treasury Management Panel.

Vision 2008

The treasury management and investment strategies support the capital programme and revenue budgets which in turn are key to the delivery of the council's vision.

1. Legislative Framework

1.1. Members consider treasury management and investment strategies each year as a requirement of the CIPFA Code of Practice on Treasury Management in the Public Services; the updated version of which cabinet formally adopted on 22 March 2002.

1.2. The 2003 Prudential Code for Capital Finance in Local Authorities (the Prudential Code) introduced new requirements for the way in which capital investment plans are considered and approved. In addition, the Code introduced more integration with authorities' treasury management strategies and the council's medium term financial plan.

1.3. The corporate revenue budget for 2005/06 - 2009/10 contains prudential indicators and borrowing limits for treasury management activities in 2005/06. This provides a framework through which the authority's treasury management and investment strategy is monitored.

1.4. The Code requires the council to set a number of prudential indicators (PCI's). These effectively replace the borrowing limits and profiles that in previous years were submitted for approval, which set limits on maximum total borrowing, temporary borrowing and on the proportion of borrowing at variable interest rates. The PCI's cover a period of three years.

1.5. All financial activities by the council are covered by the strategies and funds managed on behalf of schools and street lighting PFI receive the benefit from interest gained (in the region of £0.583m).

2 Annual Treasury Management Strategy 2005/6

2.1. The treasury management strategy for 2005/06 and onwards appears in **Appendix 1**. The borrowing objectives within that strategy are proposed to be:

- To minimise the revenue costs of debt whilst maintaining a balanced loan portfolio
- To manage the Council's debt maturity profile, ensuring no single future year has a disproportionate level of repayments
- To maintain a view on current and possible future interest rate movements and borrow accordingly
- To monitor and review the balance between fixed and variable rate loans against the background of interest rate levels.

2.2. The strategy will take account of the prevailing economic environment and current and forecast interest rates. As always, it is difficult to predict accurately, with many analysts making conflicting predictions. For example, if confidence in world markets increases, the demand for gilts will decrease and yield rates on gilts will increase. PWLB interest rates tend to follow gilts so they may also increase. The authority needs to therefore take out loans at low points in a general rising market. It is therefore expected that the authority's average rate of borrowing is likely to increase. This forecast is consistent with current surveys of economic outlooks.

2.3. For new borrowing, it is also recommended that the strategy should be to borrow long term to finance the capital programme at the lowest rate available during the year, and for short term borrowing and lending to be undertaken at the best rates available; consistent with low risk.

2.4. To integrate the treasury management strategy with the prudential code, the strategy also contains 5 specific aims that may be monitored and measured alongside the PCI's. The specific key objective is to maintain a balanced portfolio with an average rate of less than 5%.

Borrowing requirements 2005/06 and associated risks

2.5. Currently the main risk to be managed is the volatility of the variable interest rate changes. Rescheduling of loans in has reduced the number of scheduled interest rate changes over the next five years from 36 to 19. The council's loan debt currently comprises 79% fixed rate loans and 21% at variable rate. The volatility could impact on the medium term financial strategy. The recent risk assessment undertaken shows a possible impact of between £0.100m and £0.400m. This will be managed by monitoring the movements of fixed and variable rates.

2.6. The return on the council's short term cash balances is also volatile but not as significant; it being dependent on both the level of balances and interest rates. The budget for 2005/6 is £1.9m. The recent risk assessment shows a possible negative impact of £0.250m if interest rates drop by 0.5%. This will be managed by monitoring cash flows and available investment rates.

2.7. The final 2005/6 RSG settlement has provided the authority with supported borrowing of £11.045m. **Table 1** shows the estimate of mainstream resources from 2005/6 to 2009/2010 to support the capital programme. It shows a borrowing requirement of £80m over the next 3 years. During this period the authority plans to set aside for debt repayment, thus the net increase in borrowing is expected to be £37m.

Table 1 – Estimate of Mainstream Resources 2005/6 to 2009/2010 (£M)

Borrowing Type	**2005/6**	**2006/7**	**2007/8**	**2008/9**	**2009/10**
Supported borrowing lucation	2.420	1.438	1.452	1.452	1.452
Supported borrowing ansport	4.738	14.735	20.094	20.094	20.094
Supported borrowing Other	3.887	4.500	5.000	5.000	5.000
Unsupported borrowing	12.540	6.000	2.500	2.250	2.000
Total Borrowing	23.585	26.673	29.046	28.796	28.546
Estimated Capital Receipts	14.015	10.276	6.147	5.000	5.000
Total	37.600	36.949	35.193	33.796	33.546

Use of unsupported borrowing

2.8. The prudential code allows local authorities to raise finance for capital expenditure without Government consent where they can afford to service the costs of the additional debt without government support. Prior to this local authorities' capital expenditure was constrained by government borrowing approvals. Shortfalls in government funding for capital schemes were often made up by the use of capital receipts, which in some circumstances could be lost if not used. It is now considered prudent for Walsall MBC to have a more planned use of capital receipts over the medium term and to consider whether it is more appropriate to use unsupported borrowing for capital programme shortfalls.

2.9. We are in a favourable position to take advantage of unsupported borrowing as:

- Compared to other councils, Walsall MBC has a very low average rate on its debt (3.97% for 2003/4)
- The final revenue settlement assumes an average borrowing rate of 6.3% in the calculation of our FSS and revenue support grant
- The difference between the rate paid on new borrowing is marginally less than the interest that could be expected from an equivalent investment of capital receipts.

2.10 Therefore, it is proposed to adopt a flexible approach to funding of the 2005/6 capital programme by using unsupported borrowing (USB) of up to £10m as an alternative to capital receipts or where there is a related revenue stream that may be able to fund the unsupported borrowing costs. This will secure the best value for money option and optimize use of resources. For 2005/6 onwards, further use of USB is projected and included in the capital programme. **Table 2** shows specific schemes:

Table 2 – Unsupported Borrowing 2005/06 to 2009/10

	2005/6 £m	2006/7 £m	2007/8 £m
School building repairs & infrastructure	2.0	3.0	0.0
Regenerating Walsall	1.0	1.0	1.0
Repairs: other premises	3.0	2.0	1.5
Daw End mine	3.0	0.0	0.0
Total	**9.0**	**6.0**	**2.5**
Reserve list	1.0	1.0	1.0

In addition to the USB allocated to specific schemes, it is recommended that a further £1m is earmarked for projects that may come along throughout the year that can demonstrate with thorough option appraisal, that they are self funding. Section 4 discusses how additional USB is affordable and fits well with the profile of the Council.

3. Investment strategy 2005/06 onwards

3.1. The investment strategy for 2005/6 appears at **Appendix 2**. The investment objectives within that strategy are proposed to be:

- The general policy objective for this council is the prudent investment of its treasury balances
- The council's investment priorities are:
  - The security of capital and
  - Liquidity of its investments
- All investments will be in sterling.
- The council will aim to achieve the optimum return on its investments commensurate with the proper levels of security and liquidity.

3.2. The ODPM maintains that the borrowing of monies purely to invest or on-lend and make a return is unlawful; this council will not engage in such activity. The council will maintain its investments in accordance with the ODPM's Guidance on Local

Government Investments and CIPFA's Treasury Management in Public Services: Code of Practice & Cross Sectoral Guidance Notes ("CIPFA TM Code").

Investment balances / Liquidity of investments

3.3. Based on cash flow forecasts, we anticipate fund balances in 2005/6 to range from £40m to £50m. Around £50m is expected to be received from capital grants; so there is significant scope for the management of cashflows.

3.4. The minimum proportion of the overall investments that the council will hold in short-term investments is 75%. These investments of less than 365 days are called specified investments.

3.5. Considering the council's level of balances over the next 3 years, the need for liquidity, spending commitments and provisioning for contingencies, the council has determined that 25% (approximately £10m) of overall fund balances can be prudently committed to longer term investments (i.e. those with a maturity exceeding a year). These are called non specified investments.

Cash Deficits and Surpluses

3.6. Short term cash surpluses and deficits will arise regularly during the year. It is anticipated that the majority of surplus cash will only be available on a temporary basis, as it will mainly represent working capital. Money Market Funds (MMF) can also be used for short term investments, as monies can be repaid at short notice. Generally, short term deposits are most cost effective for short term cash surpluses. Therefore, investments will normally be made through short term deposits to specific dates, with reference to the cash flow requirements, but Money Market Funds may be used if better returns can be achieved. Government regulations have allowed investment in AAA credit rated Money Market Funds since 1 April 2002, which have also shown returns above the normal 7 day rate.

3.7. Temporary loans, where both borrower and lender have the option to redeem within 12 months, are usually used to cover short term revenue cash deficits, pending the receipt of, for example, precept income. However, they may also be used to cover capital requirements in the shorter term until longer-term loans are taken out. Like deposits, most of these loans will be at fixed interest rates to specific dates.

Longer Term Cash Balances

3.8. Sometimes cash surpluses are of a longer term nature, such as core revenue balances, net creditors, accrued reserves and the PFI Sinking Fund. These balances can be used to cover financing requirements where long-term interest rates make it less cost effective to use long term loans.

3.9. If longer term cash balances are not required in lieu of borrowing, these will be placed on deposit. However, it may sometimes be prudent to place these monies in MMF's or, for larger amounts, with external cash managers to improve the returns. The council currently has £6m invested over 1 year. Given the additional freedoms for investment opportunities, the possibility of having treasury advisors will continue to be explored. At the end of the financial year, a report on the council's investment activity will be prepared as part of the annual treasury report.

4. Monitoring and prudential indicators

4.1 The prudential indicators, required to be shown for a 3 year period, should not be used as comparisons between councils because of historical differences. Walsall participates in a national benchmarking club with 60 other councils. **Table 3** compares Walsall with the group's average in 2003/4. It shows that we have an exceptionally low interest rate on debt outstanding, an about average maturity profile, and should look to improve upon the return received on investments. If we had the average rate on debt outstanding the additional cost would be £4.7m.

Table 3: Comparison with Other Councils 2003/4

	Walsall MBC	Average 60 participants	Difference £ 000
% of Debt with maturing after 2018	46.8%	50.8%	
Average rate of return on external investments	3.64%	3.71%	- 42
Average rate on debt outstanding	3.9%	6.8%	+ 4,716

4.2 Walsall MBC is a mid sized metropolitan authority. Of 36 metropolitan councils it has the 17th largest population, 19th largest FSS allocation and 20th largest revenue budget. T**able 4** shows that Walsall is in the lowest quartile for financing costs, and in the lowest quartile for borrowing limits and proportion of debts over 10 years old. We have used prudential borrowing at a level just above the lower quartile, but the impact of this borrowing was above the upper quartile. The reasons for this could be other authorities have used prudential borrowing for invest to save schemes so it has very little impact on council tax as they have taken out matching long term loans.

Table 4 : Comparison of Prudential Indicators Walsall MBC with other Metropolitan Authorities 2004/0

Prudential indicator	Walsall	Lower Quartile	Median	Upper Quartile
Financing costs to revenue streams	4.06%	4.3%	5.4%	6.6%
Estimate change in council tax	£7.76	£3.77	£5.42	£7.02
Operational limit for external debt	£215m	£215m	£334m	£1,330m
Maturity Structure 10 years and above limit	90%	90%	90%	100%
Budgeted unsupported borrowing	£3.3m	£2.5m	£7.7m	£11.3m

4.3 If Walsall MBC wished to set a strategy to be at the median level as per the survey, it could plan to annually increase capital financing costs by 0.25%. The borrowing this funded would be (say) 20 years in line with the median profile. This would provide an extra £8 m per year for capital resources. To ensure a neutral effect on council tax, the option appraisal analysis on this capital expenditure would need to be able to demonstrate that using the whole life costing concept, it would be neutral.

4.4 As PCI 2, discussed below, shows, the net capital financing costs are not significant in relation to the overall revenue budget. However, a major and unexpected shift in the level of interest rates would result in increased costs to the council. This risk is monitored through indicator L7 which measures the adverse effect of a 1% increase in interest rates.

4.5 Investment counterparty risk is controlled by the using suitable criteria for assessing and monitoring the credit risk of borrowers and the construction of the lending list comprising time, type, sector and specific counterparty limits. This is authorised by the treasury management policy statement, approved by cabinet in November 2004. The performance of brokers is reviewed on a quarterly basis to ensure best returns are achieved.

4.6 Monitoring progress against the national and local indicators is undertaken throughout the year, particularly the two borrowing limits, which will need to be kept under constant review. Cabinet will be kept informed of any issues that arise. Cabinet will also be kept up to date in the regular capital Monitoring reports and in the interim treasury report in the autumn.

4.7 Within the operational boundary and authorised limit, the elements for borrowing and other long term liabilities are clearly identifiable and require approval by cabinet and Council. However, in order to give operational flexibility, cabinet are asked to delegate to the Executive Director (Chief Finance Officer) the ability to effect movements between the two elements, in accordance with the results of option appraisals and perceived best value for money for the authority (e.g. it may be most cost effective to fund elements of the capital programme from USB rather than via lease, or vice versa). Any such changes will be reported to the cabinet portfolio holder for finance and performance and to cabinet retrospectively.

PRUDENTIAL INDICATORS FOR 2005/06, 2006/07 & 2007/08

4.8 National and local indicators that will be monitored are detailed below. Their aim is to ensure two principles contained within the prudential code are complied with, ie: affordability, prudence and sustainability.

4.9 **National Prudential Indicators**

Table 5 details the proposed national prudential indicators for Walsall MBC from 2005/6 to 2007/8. More details on prudential indicators 11 and 12 are in **Appendix 3.**

Table 5: National Prudential Indicators 2005/6 to 2007/8				
No.	**Indicator**	**2005/6**	**2006/7**	**2007/8**
Comment				
PCI 1	**Total Capital Expenditure**	**£95,608,310**	**£64,304,952**	**£69,273,552**
Reduces in later years due to uncertainty on future grants and other capital resources.				
PCI 2	**Estimates of the ratio of financing costs to the net revenue stream**	**4.11%**	**4.56%**	**4.92%**
Compared to other councils Walsall's is very low, most financing costs will continue to be funded from central Government. The local indicator of comparison of the unsupported financing costs to revenue stream should be more revealing.				
PCI 3	**Estimates of the council tax that would result from the expenditure**	**£4.84**	**£9.68**	**£9.68**

	plans.			
This aims to show the actual impact of the capital investment decisions.				
PCI 4	**Estimates of capital financing requirement.**	**£227,676,000**	**£242,967,000**	**£259,604,000**
This represents the underlying level of borrowing needed to finance historic capital expenditure. To ensure that net borrowing will only fund capital, except in the short term, net external borrowing should not exceed the total capital financing requirement in the preceding year plus estimated capital financing needs for the current and next two years.				
PCI 5	**Authorised limit for external debt.**	**£250,443,000**	**£267,264,000**	**£285,565,000**
The council may not breach the limit it sets, so it is important this allows prudent room for uncertain cash flow movements and borrowing in advance of future need.				
PCI 6	**Operational boundary for external debt.**	**£227,676,000**	**£242,967,000**	**£259,604,000**
This has been set at the level of capital financing requirement.				
PCI 7	**Net Borrowing exceeds Capital Financing Requirement**	**No**	**No**	**No**
The capital financing requirement (CFR) represents the underlying level of borrowing needed to finance historic capital expenditure. Actual net borrowing should be lower than this because of strong positive cash flow and balances, and it would be a cause for concern if net borrowing exceeded the CFR figure.				
PCI 8	**Compliance with CIPFA Code of Practice for TM in the Public Services.**	**Yes**	**Yes**	**Yes**
To ensure that treasury management activity is carried out within best professional practice.				
PCI 9	**Upper limits on fixed interest rate exposures.**	**95%**	**95%**	**95%**
The council cannot control interest rates, but a relatively high degree of interest cost stability can be achieved by limiting its exposure to variable rates and by managing the long term debt maturity profile so that not too much fixed rate debt will mature in any year.				
PCI 10	**Upper limits on Variable interest rate exposures. 3.**	**40%**	**40%**	**40%**
See comment under PCI 9.				
PCI 11	**Lower limits for the maturity structure of borrowings: 4.**	**See Appendix 3**		
Stability can also be managed by the long term debt maturity profile so that not too much fixed rate debt will mature in any year.				
PCI 12	**Upper limits for the maturity structure of borrowings:**	**See Appendix 3**		
See comment under PCI 9.				
PCI 13	**Upper limit for principal sums invested for periods longer than 364 days.**	**£10,000,000**	**£10,000,000**	**£10,000,000**
The council is also at risk when lending temporarily surplus cash. The risk will be limited by investing surplus cash in specified investments and by applying lending limits and high credit worthiness.				

4.10 **Local Prudential Indicators**

Table 6 sets out local prudential indicators proposed for 2005/6 to 2007/8.

Table 6: Local Prudential Indicators 2005/6 to 2007/8				
No.	**Indicator**	**2005/6**	**2006/7**	**2007/8**
Comment				
L.1	**Full compliance with code**	**YES**	**YES**	**YES**
L.2	**Average Length of Debt**	**20 to 25 years**	**20 to 25 years**	**20 to 25 years**
This is a quick maturity measure and ideally should match the lifespan of assets.				
L.3	**Capital Financing costs versus formula spending share block**	**79%**	**88%**	**96%**
This shows the level to which the authority's capital financing costs are compared with the amount the Government provides for through the Formula Spending Share. This will assess the adequacy of Government support received for supported borrowing. The high increase is mainly due to a reduction in the commutation grant.				
L.4	**Ratio of Unsupported financing costs to revenue stream**	**0.61%**	**0.81%**	**0.93%**
Provides further detail on the significance of USB in relation to the total revenue budget				
L.5	**Actual Debt versus Operational Debt**	**89%**	**90%**	**90%**
This monitors the authority's debt position.				
L.6	**Average interest rate of external debt outstanding**	**4.77%**	**4.77%**	**4.77%**
This is compared with the PWLB rate for loans with a maturity date of 20 years, which is equivalent to the average maturity date of loans outstanding.				
L.7	**Gearing effect on Capital Financing costs of 1% increase in interest rate**	**5%**	**5%**	**5%**
This integrates risk management into the monitoring of the TM strategy.				
L.8	**Average interest rate received on short term investment**	**4.5%**	**4.5%**	**4.5%**
A recognised PI for measuring the performance of the return on investments				
L.9	**Average interest rate received on STI Versus 7 day Libor rate**	**0.1%**	**0.1%**	**0.1%**
This compares the interest gained on surplus funds with the 7 day LIBOR rate which is the rate banks offer and is an accepted measure of performance.				
L.10	**Average rate on all investments**	**4.6%**	**4.6%**	**4.6%**
As L6. but includes investments longer than 364 days				
L.11	**% daily bank balances within target range**	**98%**	**98%**	**98%**
This measures how good our daily cash flow prediction is.				

4.11 The monitoring of the indicators will be undertaken monthly and considered quarterly by the Finance Treasury Management panel that reports to the Finance service's senior management team and the Chief Finance Officer.

Background Papers:

Corporate Revenue Budget 2005/06 – 2009/10 Cabinet 19.01.05
Annual review of treasury management policy statement and annual report on treasury management activity for 2003/4 – Cabinet 1.12.04.

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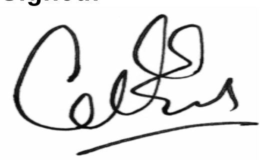
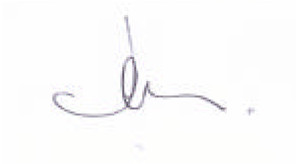
Signed: 	**Signed:** 
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Executive Director: Carole Evans	**Portfolio Holder: Cllr J G O'Hare**
Date: 31.01.05	**Date: 31.01.05**

APPENDIX 1

Treasury management strategy 2005/6 to 2007/8

key objectives

- To minimise the revenue cost of debt whilst maintaining a balanced loan portfolio
- To manage the council's debt maturity profile, ensuring no single future year has a disproportionate level of repayments
- To maintain a view on current and possible future interest rate movements and borrow accordingly
- To monitor and review the balance between fixed and variable rate loans against the background of interest rate levels
- Surplus cash balances are invested for maximum return at no risk or optimum return with proper levels of security

Specific objectives

- Full compliance with the Prudential Code
- Actual debt as a proportion of operational debt range is maintained at between 80%- 95%
- Average interest rate of external debt outstanding will be less than 5%
- Average maturity date between 20 and 25 years
- Capital financing costs as a percentage of FSS capital financing costs < 90%
- The gearing effect on capital financing estimates of 1% increase in interest rates increase must not be greater than 5%.

APPENDIX 2

Investment strategy 2005/6 to 2007/8

Key objectives

- The general policy objective for this council is the prudent investment of its treasury balances

- The council's investment priorities are:

    - o The security of capital and
    - o Liquidity of its investments.

- All investments will be in sterling

- The council will aim to achieve the optimum return on its investments commensurate with the proper levels of security and liquidity.

Specific objectives

- Average interest rate received on short term investment - > 4.5%

- Average interest rate received on STI Versus 7 day Libor rate – 0.1%

- Average rate on all investments >4.6%

- % daily bank balances within a target range of 98%

- A maximum of £10m is invested over a period over 365 days

APPENDIX 3

Prudential indicators – additional information

	2005/06	2006/07	2007/08
PCI 10. Lower limits for the maturity structure of borrowings:			
- Under 12 Months	0%	0%	0%
- 12 months and within 24 months	0%	0%	0%
- 24 months and within 5 years	0%	0%	0%
- 5 years and within 10 years	10%	10%	10%
- 10 years and above	40%	40%	40%
PCI 11. Upper limits for the maturity structure of borrowings:			
- Under 12 Months	15%	15%	15%
- 12 months and within 24 months	20%	20%	20%
- 24 months and within 5 years	25%	25%	25%
- 5 years and within 10 years	50%	50%	50%
- 10 years and above	85%	85%	85%