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OXFORD CITY COUNCIL

Report of: Finance & Asset Management Business Manager

To: Executive Board

Date: 3rd April 2006 **Item No:**

Title of Report : Treasury Management Strategy 2006/07

Summary and Recommendations

Purpose of report: To seek approval of the Treasury Management Strategy and Prudential Indicators for 2006/07 onwards.

Key decision: No

Portfolio Holder: Councillor Alex Hollingsworth

Scrutiny Responsibility: Finance

Ward(s) affected: All

Report Approved by: Jeremy Thomas, Head of Legal and Democratic Services

Policy Framework: Sustaining Financial Stability

Recommendation(s): The Executive Board is asked to recommend Council to:

1. Adopt the prudential indicators and limits for 2006/07 to 2008/09 at Appendix A
2. Approve the Treasury Management Strategy 2006/07 at Appendix B, and the treasury prudential indicators.
3. Approve the Investment Strategy 2006/07 contained in the Treasury Management Strategy (Appendix B), and the detailed criteria included in Appendix C. Specifically approving:

   - The criteria for specified investments
   - The criteria for non-specified investments

Introduction

1. This report shows the Council's prudential indicators for 2006/07 to 2008/09 and sets out the expected treasury operations for this period. It contains three key Council reporting requirements:
   - The reporting of the prudential indicators as required by the CIPFA Prudential Code for Capital Finance in Local Authorities (Appendix A);
   - The treasury strategy in accordance with the CIPFA Code of Practice on Treasury Management (Appendix B);
   - The investment strategy in accordance with the ODPM investment guidance (within Treasury Strategy at Appendix B).

2. All of the indicators within this report and the appendices are calculated from data incorporated within the three-year budgets approved by Council on 20th February 2006 and the Treasury and Investment strategies set out in Appendix B mirror those currently in operation. This report fulfils a statutory requirement for the Council to formally consider and approve these matters.

3. The capital expenditure and treasury procedures are now firmly established. The Council has freedom over capital expenditure so long as it is prudent, affordable and sustainable. In order to show it is working within these limits the Council must approve, revise and monitor a range of prudential indicators covering the forthcoming three years. The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. This report revises the indicators for 2005/06, 2006/07 and 2007/08, introduces new indicators for 2008/09 and shows the 2004/05 actual results. The indicators either summarise the expected activity or introduce limits upon the activity, and reflect the underlying capital appraisal systems.

4. Within this overall prudential framework there is a clear impact on the Council's treasury management activity, either through borrowing or investment activity. As a consequence the Treasury Management Strategy for 2006/07 is included as Appendix A to complement the indicators. This report also includes the prudential indicators relating to the treasury activity. The production of the Treasury Management Strategy is a requirement of the CIPFA Code of Practice on Treasury Management, and compliance with this Code is required by the Prudential Code.

The Capital Expenditure Plans

5. The Council's capital expenditure plans are summarised below and this forms the first of the prudential indicators. The total expenditure is partially funded by resources such as capital receipts and capital grants. Any remaining expenditure, which cannot be immediately funded from other resources, will form a borrowing need.

6. A certain level of capital expenditure will be grant supported by the Government; anything above this level will be unsupported and be paid for from the Council's own resources.

7. There are two main limiting factors which may impact on the Council's ability to undertake unsupported capital expenditure:

- Whether the revenue resource is available to support in full the implications of capital expenditure, both borrowing costs and running costs.

- The Government may use a long stop control to limit either the total of all councils' plans, or in the event of an assessment by Central Government that local plans are unaffordable at a specific council, it may implement a local control to limit its capital expenditure plans. No such control was implemented during 2005/06, and the situation for 2006/07 is unclear at the moment.

8. The key risks to the plans are that the level of Government support has been estimated and is therefore subject to change. Similarly some of estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale.

9. The Council is asked to approve the summary capital expenditure projections below; this forms the first prudential indicator:

	2004/05 Actual (£m)	**2005/06 Revised (£m)**	**2006/07 Estimate (£m)**	**2007/08 Estimate (£m)**	**2008/09 Estimate (£m)**
Capital Expenditure					
Total expenditure	18.8	21.7	22.7	14.2	13.6
Financed by:					
Capital receipts	4.3	6.1	2.1	5.2	2.4
Capital grants	9.2	8.1	8.1	5.3	5.2
Capital reserves			6.5	0.4	1.5
Revenue	2.8	5.9	3.2	2.8	3.9
Net financing need for the year	**2.5**	**1.6**	**2.8**	**0.5**	**0.6**

The Council's Borrowing Need (the Capital Financing Requirement)

10. The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total outstanding capital expenditure that has not yet been paid for from either revenue or capital resources. It is essentially a measure of Council's underlying borrowing need. The net financing need in the table above will impact directly on the CFR. The Council is asked to approve the CFR projections below:

	2004/05 Actual (£m)	2005/06 Revised (£m)	2006/07 Estimated (£m)	2007/08 Estimated (£m)	2008/09 Estimated (£m)
Capital Financing Requirement					
CFR – Non Housing	0	0	2.2	2.2	2.2
CFR - Housing	2.5	4.1	4.7	5.2	5.8
Total CFR	**2.5**	**4.1**	**6.9**	**7.4**	**8.0**
Movement in CFR	**2.5**	**1.6**	**2.8**	**0.5**	**0.6**
Movement in CFR represented by					
Net financing need for the year (above)	2.5	1.6	2.8	0.5	0.6
MRP/VRP and other financing movements	0	0	0	0	0
Total movement	**2.5**	**1.6**	**2.8**	**0.5**	**0.6**

* MRP and VRP are the minimum revenue provision and any voluntary revenue provision which represents the revenue charge for the repayment of debt.

11. The expected impact of the capital expenditure decisions above on the Council's debt and investment position are shown in the treasury strategy.

Limits to Borrowing Activity

12. Within the prudential indicators there are a number of key indicators to ensure the Council operates its activities within well defined limits

13. For the first of these the Council needs to ensure that its total borrowing net of any investments, does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2006/07 and next two financial years.

	2005/06 Revised (£m)	2006/07 Estimated (£m)	2007/08 Estimated (£m)	2008/09 Estimated (£m)
Gross Borrowing	11.8	11.3	10.8	7.2
Other long-term liabilities	2.5	2.3	2.1	1.9
Total debt	14.3	13.6	12.9	9.1
Investments	53.0	48.6	45.0	34.8
Net Borrowing	-38.7	-35.0	-32.1	-25.7
CFR	4.1	4.7	5.2	5.8

14. The Strategic Director, Finance and Corporate Services reports that the Council complied with this prudential indicator in 2005/2006 and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals the approved budget.

15. A further two prudential indicators control or anticipate the overall level of borrowing. These are:

The authorised limit – This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by members. It reflects the level of external debt that, while not desired, could be afforded in the short term, but is not sustainable in the longer term. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003*.*

The operational boundary –This indicator is based on the probable external debt during the course of the year; it is not a limit. Actual external debt could vary around this boundary for short times during the year. It should act as a monitoring indicator to ensure the authorised limit is not breached.

16. The Council is asked to approve the following authorised limit and operational boundary:

Authorised limit for external debt	**2005/06 Revised (£m)**	**2006/07 Estimated (£m)**	**2007/08 Estimated (£m)**	**2008/09 Estimated (£m)**
Borrowing	20	20	25	25
Other long term liabilities	4	4	4	4
Total	24	24	29	29
Operational boundary for external debt				
Borrowing	17.5	17.5	20	20
Other long term liabilities	3	3	3	3
Total	20.5	20.5	23	23

Affordability Prudential Indicators

17. The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the overall Council's finances. The Council is asked to approve the following indicators:

18. **Actual and Estimates of the ratio of financing costs to net revenue stream** – This indicator identifies the trend in the cost of capital

(borrowing and other long term obligation costs net of investment income) against the net revenue stream.

Ratio of financing costs to net revenue stream

	2004/05 Actual	2005/06 Revised	2006/07 Estimated	2007/08 Estimated	2008/09 Estimated
Non-HRA	-6.1%	-4.1%	-3.7%	-4.0%	-3.4%
HRA	6.8%	9.3%	10.0%	8.4%	8.4%

19. The estimates of financing costs include current commitments and the proposals in the approved budget.

20. **Estimates of the incremental impact of capital investment decisions on the Council Tax** – This indicator identifies the trend in the cost of proposed changes in the three year capital programme recommended in this budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of government support, which is not published over a three-year period.

21. **Incremental impact of capital investment decisions on the Band D Council Tax**

	Proposed Budget 2006/07	Forward Projection 2007/08	Forward Projection 2008/09
Council Tax - Band D	£9.90	£4.20	£5.43

22. **Estimates of the incremental impact of capital investment decisions on Housing Rent levels** – Similar to the Council tax calculation this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in the approved budget compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

23. **Incremental impact of capital investment decisions Housing Rent levels**

	Proposed Budget 2006/07	Forward Projection 2007/08	Forward Projection 2008/09
Weekly Housing Rent levels	£1.35	£1.06	£0.85

Appendix B

Treasury Management Strategy 2006/07 – 2008/09

1. The treasury management service is an important part of the overall financial management of the Council's affairs. Whilst the prudential indicators in Appendix A above consider the affordability and impact of capital expenditure decisions, the treasury service covers the effective funding of these decisions. There are specific treasury prudential indicators included in this strategy that need approval.

2. The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). This Council adopted the Code of Practice on Treasury Management and as a result adopted a Treasury Management Policy statement (Executive Board 7th February 2005). This adoption meets the requirements of the first of the treasury prudential indicators.

3. The Treasury Management Policy requires an annual strategy to be reported to Executive Board outlining the expected treasury activity for the forthcoming 3 years.

4. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service.

5. This strategy covers:

   - The current treasury position
   - The expected movement in interest rates
   - The Council's borrowing and debt strategy
   - The Council's investment strategy (in compliance with the ODPM guidance)
   - Treasury performance indicators
   - Specific limits on treasury activities
   - Local treasury issues

Treasury Position

	2004/05 Actual (£m)	2005/06 Revised (£m)	2006/07 Estimated (£m)	2007/08 Estimated (£m)	2008/09 Estimated (£m)
External Debt					
Borrowing	13.2	11.8	11.3	7.7	7.2
Other long term liabilities	2.7	2.5	2.3	2.1	1.9
Debt at 31 March	15.9	14.3	13.6	9.8	9.1
Annual change in debt		-1.6	-0.7	-3.8	-0.7
Investments					
Total Investments at 31 March	53.0	48.6	45.0	34.8	34.8
Investment change		-4.4	-3.6	-10.2	0
Revenue Budgets					
Interest on Borrowing	1.5	1.4	1.3	1.0	0.9
Related HRA subsidy					
Investment income	2.8	2.5	2.3	2.1	1.8

Expected Movement in Interest Rates

6. The Monetary Policy Committee announced the long-awaited cut in base rates following its August meeting. However, the downturn in the UK interest rates cycle is expected to be prolonged and shallow with the low point not being too wide of the 4.25% level (currently 4.5%). GDP growth had been substantially weaker than anticipated as the slowdown in house price inflation and higher debt servicing costs combined to undermine consumer spending growth. Activity is expected to stage a recovery in 2006.

7. The Bank of England believes that the rebound in consumer activity, together with continued strength in public sector spending and a rise in corporate investment, will encourage higher growth in the future. This is open to debate and it is clear that the forecasting of interest rates in the current climate is difficult and a cautious approach is needed in treasury activity

8. The international economic situation creates further uncertainty in the forecast. UK longer-term interest rates have been influenced by US interest rates, which currently appear unrealistically low, and there continues to be risk of an upward shift in rates. The exact timing of this is however difficult to predict.

9. **Medium-Term Rate Forecasts*** – Annual Averages %

Percent	Base Rate	5-year Gilt	20-yr Gilt
2005/06	4.6	4.2	4.3
2006/07	4.3	4.4	4.5
2007/08	4.5	4.5	4.5
2008/09	4.8	4.8	4.7

* Butlers' forecasts (January 2006)

10. There are significant risks to the forecast, which expects positive but low world and UK economic growth. Further weakness in growth could see short and longer term rates return to historic lows, although there is a higher probability within the forecast that rates will return to historic norms and shift to a higher level.

Borrowing and Debt Strategy 2006/07 – 2008/09

11. The growing uncertainty over future interest rates increases the risks associated with treasury activity. As a result the Council will take a cautious approach to its treasury strategy.

12. Long-term fixed interest rates are expected to rise modestly and base rates are expected to fall initially by ¼% before rising again in 2007/08. The Strategic Director, Finance and Corporate Services, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above. It is likely that longer term fixed rates will be considered if borrowing levels remain relatively low.

13. The expected borrowing requirement is:

	2005/06 Revised (£m)	2006/07 Estimate (£m)	2007/08 Estimate (£m)	2008/09 Estimate (£m)
Movement in CFR	1.6	0.6	0.5	0.6
Maturing Debt	1.6	0.7	3.7	0.8
Total borrowing need	3.2	1.3	4.2	1.4

Investment Strategy 2006/07 – 2008/09

14. The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.

15. The Strategic Director, Finance and Corporate Services will maintain a counterparty list in compliance with the following criteria and will review the criteria and submit them to Council for approval annually or as required

16. The counterpart list as at 31st March 2006 is attached at Appendix D for information.

17. The criteria recommended for approval are:

- **Banks** – the Council will use banks which have at least the following Fitch or equivalent ratings:
  - **Short Term** – *F2/P2*
  - **Long Term** – A/A3
  - **Individual / Financial Strength** – D-
  - **Support** – *5*
- **Building Societies** – the Council will use all Societies with assets in excess of *£0.5 billion*
- **Money Market Funds** – *AAA*
- **UK Government** (including gilts and the DMO)
- **Local Authorities, Parish Councils etc**
- **Supranational institutions**

18. The time limits for institutions on the Council's Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):

	Fitch	**Moody's**	**Standard & Poors**	**Money Limit**	**Time Limit**
Upper Limit Category	*F1+/AA-*	P-1	A-1	£8.0m	>364 days
Middle Limit Category	F1/A-	P-2	A-3	£5.0m	<365 days
Lower Limit Category	Asset base up to £2 billion			£5.0m	183 days
Other Institution Limits	-	-	-	£8.0m	364 days

19. The proposed criteria for Specified and Non-Specified investments are shown in Appendix C for approval.

20. In the normal course of the council's cash flow operations it is expected that both Specified and Non-specified investments will be utilised for the control of liquidity as both categories allow for short-term investments.

21. The use of longer-term instruments (greater than one year from inception to repayment) will fall in the Non-specified investment category. These instruments will only be used where the Council's liquidity requirements are safeguarded. This will also be limited by the investment prudential indicator below.

22. Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of falling by ¼% in 2006 and potentially rising again in 2007. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts. It is likely that investment decisions will be made for longer periods with fixed investments rates to lock in good value and security of return if opportunities arise. The Strategic Director, Finance and Corporate Services, under delegated powers, will undertake the most appropriate form of investments depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above.

Treasury Management Prudential Indicators and Limits on Activity

23. There are four further treasury prudential indicators. The purpose of these prudential indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs*.* The indicators are:

- Upper limits on variable interest rate exposure – This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments
- Upper limits on fixed interest rate exposure – Similar to the previous indicator this covers a maximum limit on fixed interest rates.
- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.
- Total principal funds invested for greater than 364 days – These limits are set to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

24. The Council is asked to approve the following prudential indicators:

	2006/07		2007/08		2008/09	
Interest rate Exposures						
	Upper		**Upper**		**Upper**	
Limits on fixed interest rates based on net debt	100%		100%		100%	
Limits on variable interest rates based on net debt	50%		50%		50%	
Maturity Structure of fixed interest rate borrowing						
	Lower	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	0%	30%	0%	30%	0%	30%
12 months to 2 years	0%	30%	0%	30%	0%	30%
2 years to 5 years	0%	80%	0%	80%	0%	80%
5 years to 10 years	0%	50%	0%	50%	0%	50%
10 years and above	0%	50%	0%	50%	0%	50%
Maximum principal sums invested > 364 days						
Principal sums invested > 364 days	£10m		£10m		£10m	

Performance Indicators

19.23. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. An example of performance indicators often used for the treasury function relating to investments is the internal return above the 7 day LIBID rate.

Appendix C

Treasury Management Practice (TMP) 1 (5) – Credit and Counterparty Risk Management

The Office of the Deputy Prime Minister issued Investment Guidance on 12th March 2004, and this forms the structure of the Council's policy below.

The key intention of the Guidance is to maintain the current requirement for Councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council has adopted the Code and will apply its principles to all investment activity. In accordance with the Code, the Strategic Director, Finance and Corporate Services has produced its treasury management practices. This part, TMP 1(5), covering investment counterparty policy requires approval each year.

Annual Investment Strategy - The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of following:

- The strategy guidelines for decision making on investments, particularly non-specified investments.
- The principles to be used to determine the maximum periods for which funds can be committed.
- Specified investments the Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
- Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

This strategy is to be approved by full Council.

The investment policy proposed for the Council is:

Strategy Guidelines – The main strategy guidelines are contained in the body of the treasury strategy statement.

Specified Investments – These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are low risk assets where the possibility of loss of principal or investment income is small.

These would include investments with:

1. The UK Government (such as the Debt Management Office, UK Treasury Bills or a Gilt with less than one year to maturity).
2. Supranational bonds of less than one year's duration.
3. A local authority, parish council or community council.
4. An investment scheme that has been awarded a high credit rating by a credit rating agency.
5. A body that has been awarded a high credit rating by a credit rating agency (such as a bank or building society).

For category 4 this covers a money market fund rated *AAA* by Standard and Poor's, Moody's or Fitch rating agencies.

For category 5 this covers bodies with a minimum rating of AA- (or the equivalent) as rated by Standard and Poor's, Moody's or Fitch rating agencies. Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies which will be invested in these bodies. These criteria are:

Rating	**Limit**	**Time period**
F1+/AA-	£8.0m	>364 days
F1/A-	£5.0m	Up to 364 days
Building Society with Asset base up to £2bn	£2.5m	183 days
Building Society with asset base > £2bn	£5.0m	>364 days

Non-Specified Investments – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non-specified investments would include any sterling investments with:

	Non Specified Investment Category	Limit
a.	**Supranational Bonds greater than 1 year to maturity** **(a) Multilateral development bank bonds** - These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Investment Bank etc.). **(b) A financial institution that is guaranteed by the United Kingdom Government** (e.g. The Guaranteed Export Finance Company {GEFCO}) The security of interest and principal on maturity is on a par with the Government and so very secure, and these bonds usually provide returns above equivalent gilt-edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£2 million
b.	**Gilt edged securities** with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£2 million
c.	Any **bank or building society** that has a minimum long-term credit rating of A, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	£2.5 million
d.	Any **non-rated subsidiary** of a credit rated institution included in the specified investment category. These institutions will be included as an investment category subject to the credit rating of the parent company meeting the counterparty criteria set out in paragraph 17 of Appendix B.	£2.5 million
e.	**Share capital or loan capital** in a body corporate – The use of these instruments will be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. Revenue resources will not be invested in corporate bodies.	£0.25 million

Within categories c and d, and in accordance with the Code, the Council has developed additional criteria to set the overall amount of monies that will be invested in these bodies. These criteria specify that the total of Non-specified investments must not exceed £10 million, and that the total investment with any individual counterparty must not exceed £2.5 million at any time.

The Monitoring of Investment Counterparties - The credit rating of counterparties will be monitored regularly. The Council receives credit rating advice from its advisers, Butlers, on a daily basis as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Strategic Director, Finance and Corporate Services, and if required new counterparties which meet the criteria will be added to the list.

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Background papers:

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