G

NEW FOREST DISTRICT COUNCIL

CABINET 3 MARCH 2004

TREASURY MANAGEMENT STRATEGY REPORT 2004/05

1. INTRODUCTION

1.1 The Chartered Institute of Public Finance and Accountancy (CIPFA) and the Office of the Deputy Prime Minister (ODPM)/Wales have, for a number of years, been discussing the possibility of releasing councils from restrictions on capital spending. The result of these discussions has been the publication of the Prudential Code for Capital Finance in Local Authorities (the Code). This is a professional Code that sets out a framework for self-regulation of capital spending, in effect allowing councils to invest in capital projects without any limit as long as they are affordable, prudent and sustainable. This comes into force for 2004/05 and the Council is now allowed to determine the appropriate level of capital investment to properly deliver quality public services, subject to affordability.

1.2 The primary change is that the current credit approvals (BCAs and SCAs), will be abolished and there will be no restriction on capital investment, subject to Government reserve powers to restrict borrowing for national economic reasons. With the abolition of the BCA/SCA framework, capital investment will be supported through Supported Capital Expenditure (Revenue) - single capital pot element (for the BCA element) and Supported Capital Expenditure (Revenue) - separate program element (for the SCA element). The use of Supported Capital Expenditure (Revenue) in the capital finance calculations for 2004/05 is similar to that of credit approvals.

1.3 Members' involvement through the process is essential in order that the Council can demonstrate that capital expenditure plans are affordable, financing plans are prudent and sustainable and that treasury decisions are taken in accordance with good practice. The structure and content of this report complies with the Code.

1.4 To facilitate the decision making process and support capital investment decisions the Prudential Code requires the Council to agree and monitor a minimum number of prudential indicators. For housing authorities these are separated for the HRA and non-HRA capital investment. These indicators are mandatory, but can be supplemented with local indicators if this aids interpretation and many will cover three years forward. The indicators cover affordability, prudence, capital expenditure, external debt and treasury management. These indicators will also form the basis of in year monitoring and reporting.

1.5 The indicators are purely for internal use by the Council and are not to be used as comparators between councils, as any comparisons will be meaningless. In addition the indicators should not be taken individually; rather the benefit from monitoring will arise from following the movement in indicators over time and the year on year changes.

2. CAPITAL EXPENDITURE AND CAPITAL FINANCING REQUIREMENT

2.1 A change introduced by the Code is the calculation of the Capital Financing Requirement (CFR). This figure represents the Council's underlying need to finance its current and historic capital expenditure, which has not yet been charged to revenue. The change year on year will be influenced by the capital expenditure within the year.

2.2 As the Council will be "Debt Free" by the 31 March 2004 the CFR will be zero at that date. This means that the sum of its current and historic capital expenditure is fully funded and additional resources (primarily capital receipts) are available over and above this for capital spending or support of the revenue budget.

2.3 The expected movement in the CFR over the next three years is dependent on the level of supported and unsupported capital expenditure decisions taken during the budgeting cycle. Supported Capital Expenditure is set out in paragraph 1.2 above. The unsupported element is the new capital expenditure freedom allowed under the Prudential Code. The Prudential Code anticipated that these new freedoms would enable the Council to enter into projects such as spend to save schemes (which may have previously been limited by the credit approval limits), or decisions to allocate additional resource from revenue to capital to enable service enhancements.

2.4 There are two main limiting factors 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 resource costs (i.e. interest receipts lost through use of reserves and interest costs from raising debt), and running costs. Can the Council afford the implications of the unsupported capital expenditure?

- The Government may use a long stop control to ensure that either the total of all councils' plans do not jeopardise national economic policies, or in the event of an assessment by Central Government that local plans are unaffordable at a council, it may implement a specific control to limit its capital expenditure plans. Details of these controls have yet to be finalised.

2.5 The Council's estimates for the CFR in the next three years are shown in the table below, with the associated expectation for funding for the change in the CFR between years. This forms one of the required prudential indicators. Included also is the related capital expenditure figures for each year, split between supported and unsupported spending, and the expected external debt for each year. Both of these are also mandatory prudential indicators. If no borrowing is anticipated in future years the CFR will show as nil to comply with the Code.

2.6 A key risk of the plan is that the level of government support has been estimated and is therefore subject to change. Similarly some of the estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale.

2.7 The Council is asked to approve the actual and estimated CFR and actual debt figures:

	2002/03 Actual £000	2003/04 Latest Forecast £000	2004/05 Estimate £000	2005/06 Estimate £000	2006/07 Estimate £000
Capital Expenditure					
Supported spend	2178	2208	1874	1854	3409
Unsupported spend	10473	10381	9169	6979	13023
Total spend	12651	12589	11043	8833	16432
Financed by:					
Borrowing	0	0	0	0	00
Capital receipts	2022	972	2932	2732	2732
Capital grants	1871	1683	1502	1407	7862
Capital Reserves	2709	4771	2615	600	1644
Revenue	6049	5163	3994	4094	4194
Capital Financing Requirement					
CFR – Non Housing	-418	-2785	-2785	-2785	-2785
CFR - Housing	6056	2785	2785	2785	2785
Total CFR	5638	0	0	0	0
Net movement in CFR		-5638	0	0	0
External Debt					
Borrowing	10635	0	0	0	0
Other long-term liabilities	0	0	0	0	0
Total Debt - 31 March	10635	0	0	0	0

2.8 The following table shows the breakdown of Capital Expenditure by Service.

Service	2002/03 Actual £000	2003/04 Latest Forecast £000	2004/05 Estimate £000	2005/06 Estimate £000	2006/07 Estimate £000
Corporate & Finance	474	887	460	228	110
Crime & Disorder	565	33	0	100	0
Environment	693	2265	1421	1288	9387
Economy & Planning	115	336	261	0	0
Leisure	1069	2693	2051	367	85
Housing (non HRA)	3935	2789	3099	3099	3099
Total non- HRA	**6851**	**9003**	**7292**	**5082**	**12681**
Total HRA -	5800	3586	3751	3751	3751
Total	**12651**	**12589**	**11043**	**8833**	**16432**

2.9 Major Changes in the Level of Capital Expenditure on Services

Using the 2003/04 figures as a base, the following table shows the major changes in the level of capital expenditure on services. Only Leisure Services and Environment Services are shown as this is where the major changes have occurred.

	2004/05 Estimate £000	2005/06 Estimate £000	2006/07 Estimate £000
Leisure			
Hanger Farm	-1000	-640	0
Ringwood Refurbishment	400	-400	0
Lymington Phase 2	400	-400	0
Other various	-442	-244	-282
Total Leisure	**-642**	**-1684**	**-282**
Environment			
Coast Protection - Strategic Coastal Monitoring	-525		
Coast Protection - Christchurch Bay Beach			4000
Coast Protection - Milford on Sea			2840
Coast Protection - Hurst Spit Management			1315
Coast Protection - Other	207		-55
Land Drainage - Schemes Planned	-199		
Other various	-327	-133	
Total Environment	**-844**	**-133**	**8100**

2.10 In the table at 2.8 it is assumed that the programme for private sector and public sector housing will continue for future years and will be largely unchanged from year to year. The reasons for the variation in the total estimated capital expenditure for future years are detailed in Appendix 2 of the General Fund Revenue Budget and Capital Programmes For the Financial Year 2004/05 that was approved by this Cabinet on 4 February 2004.

3. LIMITS TO BORROWING ACTIVITY

3.1 The first key control over the Council's activity is to ensure that over the medium term net borrowing will only be for a capital purpose. Whilst this Council is in a net investment position the same principle applies. The Council needs to ensure that net external borrowing does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for 2004/05 and for 2005/06 and 2006/07. This allows some flexibility for limited early borrowing for future years. The following table shows the estimated position at 31 March for each financial year.

	2003/04 Latest Forecast	2004/05 Estimate	2005/06 Estimate	2006/07 Estimate
Gross Borrowing	£9m	£0m	£0m	£0m
Investments	£18m	£7m	£6m	£4m
Net Borrowing	(£9m)	(£7m)	(£6m)	(£4m)
CFR	(£0m)	(£0m)	(£0m)	(£0m)

3.2 The Cabinet is asked to approve the following statement by the Director of Resources.

"The Director of Resources reports that the Council complied with the requirement to keep net borrowing below the relevant CFR in 2002/03, and no difficulties are envisaged for the current or future years. This view takes into account current commitments, existing plans, and the proposals in this budget report."

3.3 A further two Prudential Indicators control the overall level of borrowing which support the Council's borrowing activities. These are:

3.3.1 **The Authorised Limit**
This represents the limit beyond which borrowing is prohibited, and needs to be set and revised by members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need with some headroom for unexpected movements.

3.3.2 **The Operational Boundary**
This indicator is based on the probable external debt during the course of the year; it is not a limit and actual borrowing could vary around this boundary for short times during the year. It should act as an indicator to ensure the authorised limit is not breached.

3.4 Both of these indicators are required although for most of the year they would be nil. There will necessarily be a risk of some temporary borrowing during the course of a year for cash flow purposes and these limits reflect this possibility.

3.5 The Council is asked to approve the following authorised and operational limits:

Authorised limit for external debt		**2003/04 Forecast £m**	**2004/05 Limit £m**	**2005/06 Estimate £m**	**2006/07 Estimate £m**
Borrowing		36	22	17	18
Other long term liabilities		0	0	0	0
Total		36	22	17	18

Operational boundary for external debt	**2002/03 Actual £m**	**2003/04 Forecast £m**	**2004/05 Limit £m**	**2005/06 Estimate £m**	**2006/07 Estimate £m**
Borrowing	17	11	10	7	9
Other long term liabilities	0	0	0	0	0
Total	17	11	10	7	9

4. AFFORDABILITY PRUDENTIAL INDICATORS

4.1 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 finances. The Council is asked to approve the following indicators:

4.1.1 Financing Costs

The Council is expected to be “debt free” under the present capital control system but may in practice have debts and therefore interest payments. Short term borrowing for cash flow purposes is disregarded for the purposes of establishing whether the Council is “debt free”. The current regulations also recognise that some loans may be difficult or impossible to redeem before maturity and are therefore ignored for the purposes of determining whether an authority is “debt free”, For these reasons, in the new arrangements, the calculation of financing costs for an authority that is currently “debt free” will still include some interest payments. For debt free councils, financing costs will be negative. Income or expenditure incurred through the early repayment of debt must also be included in the financing costs.

Financing costs	2002/03 Actual £000	2003/04 Forecast £000	2004/05 Estimate £000	2005/06 Estimate £000	2006/07 Estimate £000
Interest due for short-term borrowing	15	15	15	15	15
Interest due for long-term irredeemable debt	1066	854	0	0	0
Penalties paid on early repayment of debt	402	335	423	383	219
Interest income	-1671	-1686	-1093	-1156	-1446
Replacement for MRP	-682	0	0	0	0
Total Financing costs	-870	-482	-655	-758	-1212

4.1.2 Actual and Estimates of the ratio of financing costs to the net revenue stream

This indicator identifies the trend in the cost of capital (borrowing costs net of interest and investment income) against the net revenue stream. For debt free councils this is likely to be the cost of using invested capital receipts.

	2002/03 Actual	2003/04 Forecast	2004/05 Estimate	2005/06 Estimate	2006/07 Estimate
Non-HRA	-4%	-3%	-4%	-4%	-6%
HRA	0%	0%	0%	0%	0%
Total	-4%	-3%	-4%	-4%	-6%

4.1.3 The estimates of financing costs include current capital expenditure commitments.

4.1.4 **Estimates of the incremental impact of capital investment decisions on the Band D Council Tax**

This indicator identifies the trend in the cost of proposed changes in the three-year capital programme recommended. The forward projections are based on the assumptions included in the budgets, but will invariably include some areas, such as the level of government support, which is not published over a three year period.

	Proposed Budget 2004/05	Forward Projection 2005/06	Forward Projection 2006/07
Council Tax - Band D	4.1%	2.6%	2.6%

4.1.5 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 recent budget report compared to the Council's existing commitments and current plans, expressed as a change in weekly rent levels.

The Council has adopted the Government's rent restructuring policy. As such, the unsupported element of the Capital Programme has no impact on rent levels. Any Revenue financial implications of the programme are covered from balances or through adjustments to other revenue budgets.

	Proposed Budget 2004/05	Forward Projection 2005/06	Forward Projection 2006/07
Weekly Housing Rents	£0	£0	£0

5. TREASURY MANAGEMENT STRATEGY 2004/05 – 2006/07

5.1 The treasury management service is an important part of the overall financial management of the Council's affairs. Its importance has increased as a result of the freedoms provided by the Code. It covers the borrowing and investment activities and the effective management of associated risks. Its 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 the Treasury Management Policy Statement on 25 February 2002.

5.2 The Treasury Management Policy requires an annual strategy to be reported to Cabinet outlining the expected treasury activity for the forthcoming 3 years. A further report is produced after the year-end to report on actual activity for the year.

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

5.4 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
- Treasury performance indicators
- Specific limits on treasury activities (appendix 1)
- Local treasury issues

6. CURRENT TREASURY POSITION

6.1 The Council's detailed treasury position is highlighted in the following table. This includes temporary borrowing and temporary investments as well as long-term requirements.

		31/3/2003 Actual £m	Rate	31/3/04 Estimate £m	Rate
Fixed Rate Debt	PWLB	1	10.4%	0	-
	Market	13	6.9%	9	4.0%-
Variable Rate Debt	PWLB	0	-	0	-
	Market	0	-	0	-
Total Debt		**14**	**7.4%**	**9**	**4.0%**
Other Long Term Liabilities		0	-	0	-
Total		**14**	**7.4%**	**9**	**4.0%**
Fixed Investments		-33	-4.5%	-18	-3.7%
Variable Investments		0	-	0	-
Total Investments		**-33**	**-4.5%**	**-18**	**-3.7%**
Net Borrowing		**-19**	**-2.4%**	**-9**	**-3.4%**

7. EXPECTED MOVEMENT IN INTEREST RATES

7.1 The current position of the treasury function, and its expected change in the future, presents a continuing risk to the Council from an adverse movement in interest rates. The Prudential Code is constructed on the basis of affordability, part of which is related to borrowing costs and investment returns. The Council employs treasury consultants, to advise on the treasury strategy, to provide economic data and interest rate forecasts, to assist planning and reduce the impact of unforeseen adverse movements.

7.2 For the year ahead the UK interest rate is forecast to rise. The gradual tightening of official monetary policy is anticipated as the Bank of England counters the threat to inflation from an increase in domestic and international economic activity.

7.3 Policy tightening has already affected interest rates in the money markets. It is forecast that the increase in domestic rates will be both modest and gradual.

7.4 The UK economy has performed better than had been anticipated by the Bank of England earlier this year. While inflation on all fronts has remained moderate and shows no real signs of becoming a problem over the next few years, there are a number of areas of the economy that give cause for concern. Consumer spending has remained higher than the Bank had forecast earlier this year, continued house price inflation has increased the feeling of wealth and this has fuelled strong growth in credit.

7.5 Anticipation of a weakening in these aspects, coupled with the combination of a stronger sterling performance and worries about the health of the US economy, had encouraged the Monetary Policy Committee to announce a rate cut to 3.5% in July. These fears proved ill founded and the move was reversed in November.

7.6 A further increase in the Bank of England base rate of 0.25% to 4% was announced in February.

7.7 The record indebtedness of the UK personal sector and the danger of rising interest rates could reduce spending growth and is expected to be a restraining influence upon official policy tightening in 2004. A deceleration in retail spending is anticipated but the hope is that the increase in UK competitiveness in international markets, because of sterling's depreciation since late 2002, generates an export-led recovery in the manufacturing sector.

7.8 This economic position, together with low inflation dangers, suggests that the Bank of England will not be under pressure to increase rates dramatically and will be able to achieve its aims through moderate policy tightening.

7.9 The expected movement in interest rates are as follows:

Medium-Term Interest Rate Forecasts

Percent	Base Rate	5-year Gilt	20-yr Gilt
Average 2002/03	3.9	4.4	4.6
2003/04	3.7	4.4	4.8
2004/05	4.4	5.2	5.5
2005/06	4.6	5.3	5.6
2006/07	4.8	5.3	5.6
2007/08	4.5	4.8	5.2

7.10 The key risks to these forecasts are the strength of the US recovery. Like the UK much of the growth in the US economy comes from borrowing. A fall in consumer confidence may see the US recovery falter and the upward pressure on UK short and long-term fixed rates will cease.

7.11 If, however, the US recovery increases faster than anticipated, there will be increasing inflationary pressures and a higher than expected increase in short and long-term rates.

8. BORROWING AND DEBT STRATEGY 2004/05 – 2006/07

8.1 The introduction of the Prudential Code and uncertainty over future interest rates increase the risks associated with the treasury strategy. As a result the Council will take a cautious approach to its treasury strategy.

8.2 Whilst long term fixed interest rates and base rates are both expected to rise, base rates are expected to remain relatively inexpensive for the foreseeable future. It is not anticipated that any long term borrowing will be taken in 2004/05 but The Director of Resources, under delegated powers, will take the most appropriate form of borrowing in future years if required. Any borrowing will be undertaken depending on the prevailing interest rates at the time and taking into account the risks shown in the forecast at paragraph 7.9.

8.3 The Council will borrow temporarily for cash flow purposes.

9. INVESTMENT STRATEGY 2004/05 – 2006/07

9.1 Shorter-term interest rates, on which investment decisions are based, are forecast to rise during 2004/05. The Council's investment decisions are based the Council's and adviser's own forecasts of the expected movement in interest rates and the timing of those expected movements. Currently the money markets are pricing in stronger increases than the forecasts suggest. It is likely that if this continues investment decisions will be made for longer periods with fixed investments rates to lock in good value and security of return. The Director of Resources 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 at paragraph 7.9 above.

9.2 All investments will be made in accordance with the Council's investment policies and prevailing legislation and regulations. As a result of the introduction of the Prudential Code, the Government on 1st April 2004 will implement new investment regulations. Draft regulations were issued by the ODPM on 15 December 2003, for comments by 30 January 2004. In order to comply with Council reporting requirements the investment policy has been redrafted and is contained in Appendix 1 for approval.

9.3 The following table gives an estimate of monetary activity over the three years and is given in more detail in the investment indicator at paragraph 10.10 below.

Monetary Activity	2004/05 Estimate £m	2005/06 Estimate £m	2006/07 Estimate £m
Maximum principal sums invested	35	24	25

10. TREASURY MANAGEMENT PRUDENTIAL INDICATORS AND LIMITS ON ACTIVITY

10.1 The introduction of the Prudential Code sees the replacement of the s45 limits imposed by the Local Government and Housing Act 1989, with four new prudential indicators:

- Upper limits on variable rate exposure – This indicator identifies a maximum limit for variable interest rates based upon the estimated interest receivable on the debt position net of investments. Further limits are introduced for the maximum principal sums for both investments and borrowing. This is set to cover the possibility of short-term cash flow borrowing, or the potential for borrowing in the future as well as investments held on variable rates. (Table 1)
- Upper limits on fixed rate exposure – Similar to the previous indicator this covers a maximum limit on fixed interest rates.
- Maturity structures of borrowing and lending – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing. (Table 2 and 3)

- Total principal funds invested – These limits are set to reduce the need for early sale of an investment, and are based on the availability of investments after each year-end. This covers both internally managed external investments and the holdings of external fund managers.

10.2 The purpose of these prudential indicators is to contain the activity of the treasury function within certain limits, thereby reducing the risk or likelihood of an adverse movement in interest rates or borrowing decisions impacting negatively on the Council's overall financial position.

10.3 In the Council's case being debt free reduces the importance of the two indicators relating to upper limits on fixed and variable rate exposure, although there is a requirement to set them. However if these are too restrictive they will impair any future opportunities to reduce costs. To make these statutory indicators more meaningful, separate local indicators for borrowing levels and investment levels have been calculated – this approach will enable realistic monitoring to be done during the year.

10.4 As an example - In relation to debt in 2004/05, the upper limit on fixed rate exposure is set at £10m and the upper limit on variable rate exposure is set at £5m. This is based on a borrowing limit of £10m.

10.5 In relation to investments in 2004/05, the upper limit on fixed rate exposure is set at £35m and the upper limit on variable rate exposure is set at £17.5m. This is based on an investment limit of £35m; this should be high enough to cover all eventualities during the year.

10.6 Therefore, the net exposure for fixed rate is -£25 million (-£35m investments + £10m borrowing) and for variable rate is -£12.5 million (-£17.5 m investment + £5m borrowing).

10.7 Fixed interest rate investments and borrowing are regarded as those that maintain the same interest rate for the period of the loan. Variable interest rate investments and borrowing are those that may vary the interest rate within the period of the loan. The maturity structure applies at the time and date of the agreement of the original transaction.

10.8 Table 1 only shows the maturity profile of fixed rate debt. Table 2 has been included as a local prudential indicator to show the maturity profile of total debt to include both fixed rate and variable rate borrowing.

10.9 Table 3 has been included as a local prudential indicator to show the maturity profile of total investments.

10.10 The Council is asked to approve the following prudential indicators:

Table 1	**2004/05**		**2005/06**		**2006/07**	
	Upper		**Upper**		**Upper**	
	£000		**£000**		**£000**	
Estimated interest receivable on net investments	1078		1141		1431	
Limits on Fixed Interest Rates	100%		100%		100%	
Limits on Variable Interest Rates	50%		50%		50%	
Maturity Structure of fixed borrowing	**Lower**	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	0%	100%	0%	100%	0%	100%
12 months to 2 years	0%	50%	0%	50%	0%	50%
2 years to 5 years	0%	50%	0%	50%	0%	50%
5 years to 10 years	0%	50%	0%	50%	0%	50%
10 years and above	0%	50%	0%	50%	0%	50%

Table 2 **Total Borrowing Limits**	**2004/05**		**2005/06**		**2006/07**	
	Upper		**Upper**		**Upper**	
	£m		**£m**		**£m**	
Estimated Maximum principal sums borrowed	10		7		9	
Limits on fixed interest rates	100%		100%		100%	
Limits on variable interest rates	50%		50%		50%	
Maturity Structure of Total borrowing	**Lower**	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	0%	100%	0%	100%	0%	100%
12 months to 2 years	0%	50%	0%	50%	0%	50%
2 years to 5 years	0%	50%	0%	50%	0%	50%
5 years to 10 years	0%	50%	0%	50%	0%	50%
10 years and above	0%	50%	0%	50%	0%	50%

Table 3 **Total Investments Limits**	**2004/05**	**2005/06**	**2006/07**
	Upper	**Upper**	**Upper**
	£m	**£m**	**£m**
Estimated Maximum principal sums invested	35	24	25
Limits on fixed interest rates	100%	100%	100%
Limits on variable interest rates	50%	50%	50%

Maturity Structure of Total Investments	Lower	Upper	Lower	Upper	Lower	Upper
Under 12 months	0%	100%	0%	100%	0%	100%
12 months to 2 years	0%	50%	0%	50%	0%	50%
2 years to 5 years	0%	50%	0%	50%	0%	50%

11. PERFORMANCE INDICATORS

11.1 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. The performance indicators to be set for this Council's treasury function are:

- Investments – Internal returns should be above the 7 day LIBID rate
- Investments – External fund managers net returns should be benchmarked at 7 day LIBID compounded weekly with a target return of 1.0% above that benchmark.

The results of these indicators will be reported in the Annual Treasury Report at each year-end.

12. LOCAL ISSUES

There are no local issues other than those currently included in the body of this report.

13. CONCLUSIONS

13.1 The treasury management strategy covers the operation of the treasury function and its likely activities for the forthcoming years.

13.2 The report incorporates the impact of the CIPFA Prudential Code for Capital Finance in Local Authorities, which will be implemented from 1 April 2004.

14. RECOMMENDATIONS

Members are recommended to:

14.1 Adopt the prudential indicators and limits within the report.

14.2 Approve the treasury management strategy 2004/05.

14.3 Approve the investment guidelines at Appendix 1.

14.4 Approve the statement of the Director of Resources at paragraph 3.2.

Further Information

Please contact Jan Hawker, Treasury Management Accountant Ext. 5722
e-mail: jan.hawker@nfdc.gov.uk

Background Papers

The Prudential Code & CIPFA Guidance Notes.
General Fund Revenue Budget and Capital Programme 2004/05 (Cabinet 04/02/04 Report H)
Capital Finance in Local Authorities (Cabinet 04/02/04 Report B)

APPENDIX 1

TREASURY MANAGEMENT PRACTICE 1 (5) – CREDIT AND COUNTERPARTY RISK MANAGEMENT

1. DRAFT GUIDANCE

1.1 The repeal of Part IV of the Local Government and Housing Act 1989 on 1 April 2004 also ends the current local authority approved investment regulations. The Office of the Deputy Prime Minister issued draft guidance on 15 December 2003 that, subject to the outcome of the consultation process, will replace these regulations. In common with the relaxation of borrowing controls in the prudential system, the guidance replaces the current regulatory approach.

2. ADOPTION OF THE CODE

2.1 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.

2.2 This Council adopted the Code on 25 February 2002 and will apply its principles to all investment activity. In accordance with the Code the Director of Resources has produced its treasury management practices and this part, TMP 1(5) requires amendment.

3. ANNUAL INVESTMENT STRATEGY

3.1 The key requirements of both the Code and the ODPM guidance are to set an annual investment strategy covering the identification and approval of the following:

- The strategy guidelines for decision making on investment decisions, particularly non-specified investments.
- The principles to be used to determine the amount of funds which can be committed for more than a year, and the minimum to be held in short term investments.
- 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. This will need to define broad categories of investment and the regularity of monitoring.
- 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.

3.2 It should also be noted that the nature of the change to specified/non-specified split should not be confused with approved/non-approved investments under the current system. Specified and non-specified are both approved under the new guidance and both should normally form part of a council's policy.

4. INVESTMENT POLICY

The investment policy proposed for the Council is:

4.1 Strategy Guidelines

The main principle governing the Council's investment criteria is the security and liquidity of its investments before yield, although the yield or return on the investment will be a consideration, subject to adequate security and liquidity. After this main principle the Council will ensure:

- It has sufficient liquidity in its investments. For this purpose it will set both a minimum amount to be held in short term investments (specified investments). This is set out in Liquidity of Investments below.
- 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.
- The Director of Resources will maintain a counterparty list in compliance with these criteria and will revise the list as necessary for practical use. The current proposed criteria is shown below for approval.

4.2 Liquidity of Investments

The Council expects to maintain core investment balances of £7m, for the year 2004/05 although these may rise on occasion due to cash flow reasons. The Council will therefore carefully balance the use of short term or specified investments and non-specified investments. At least 50% of the core investment balance and any cash flow investments will be maintained as short term or specified investments.

4.3 Specified Investments

These investments are sterling investments of not more then one-year maturity. These are low risk assets where the possibility of loss of principal or investment income is very low. 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. A local authority, parish council or community council.
3. An investment scheme that has been awarded a high credit rating by a credit rating agency (currently AAA Money Market Fund). This covers a money market fund rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.

4. A body, such as a bank or building society, that has been awarded a high credit rating by a credit rating agency (although low or non-rated building societies will need to be non-specified investments). This covers bodies with a minimum rating as rated by Standard and Poor's, Moody's or Fitch rating agencies and as shown in the following table:

Credit Rating Agency	Category of High Credit Rating
Fitch	F1 or F1+
Moody's	P-1
Standard & Poors	A-1 or A-1+

5. 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. This criterion is a maximum investment of £5m for 364 days.

4.4 Non-Specified Investments

Non-specified investments are any other type of investment (i.e. not defined as specified above). These would include sterling investments with:

1. Securities admitted to the Official List of The Stock Exchange, which are guaranteed by the UK Government (such as supranational bonds). These are fixed income bonds although the value of the bond may rise or fall before maturity and losses may accrue of the bond is sold before maturity.

2. Gilt edged securities with a maturity of greater than one year.

3. Institutions not meeting the basic security requirements under the specified investments. This will include non-rated building societies and banks. Building societies will fall in this category if they are beneath the basis rating for specified investments or are not rated. 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. The following table details the criteria for these investments:

Counterparty Criteria	Investment restrictions
Unrated fully owned subsidiaries of highly credit rated institutions	£3 million for up to 6 months
Unrated Building Societies with total assets greater than £500 billion.	£5 million for up to 6 months
Unrated Building Societies with total assets greater than £250 billion but less than £500 billion.	£3 million for up to 3 months
Local Authorities	£5 million for up to 4 years

4. A body such as a bank or building society that has been awarded a high credit rating by a credit rating agency, for deposits with a maturity of greater than one year.

5. The ODPM guidance specifically requires consideration and setting of maximum limits for longer-term investments. The following table shows the criteria for longer-term investments.

Long-Term Credit Rating	Period of Investment
A (+/-)	Up to 2 Years
AA (+/-)	Up to 4 Years
AAA (+/-)	Up to 5 Years

6. The longer–term investments will also need to fit in with the principles surrounding the treasury prudential indicator for total principal sums invested longer than 364 days.

7. THE MONITORING OF INVESTMENT COUNTERPARTIES

7.1 The credit rating of counterparties will be monitored regularly, as a policy at least monthly. However the Council receives credit rating advice from its advisers, on a daily basis as and when ratings change, and counterparties are checked promptly.

7.2 There will be a minor time delay between rating changes and the Council receiving notification, and on occasion ratings may be downgraded when an investment has already been made.

7.3 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 Director of Resources, and if required new counterparties which meet the criteria will be added to the list.

7.4 Any such changes will be reported to the Cabinet on a regular basis.

8. USE OF EXTERNAL FUND MANAGERS

8.1 It is the Council's policy to use external fund managers for part of its investment portfolio for the time being. The fund managers will use both specified and non-specified investment categories. The terms of the fund managers' investment policies are:

Limits and Restrictions	Policy
Benchmark	7 day LIBID rate compounded weekly.
Performance Target	Benchmark plus 1%.

Maturity Limits	Average duration for the fund will not exceed 2.5 years. Maximum proportion of Fund invested in instruments carrying rates of interest for periods longer than 364 days shall not exceed 60%. Maximum maturity of any investment shall not exceed 10 years
Currency Limits	Sterling
Permitted Investments	Investment is limited in accordance with the requirements of the Local Authorities (Capital Finance and Accounting)(England) Regulations 2003.
Exposure Limits	The Managers lending list shall apply. Counterparties with a short-term rating of F1+ according to current ratings provided by Fitch (specified investments). The maximum nominal sum, which may be lent to each name, shall be 20%. There will be no limit on investment in the obligations of the UK Government whether specified or non-specified other than those stated under maturity limits above. The manager may invest in the securities of other borrowers, as permitted under the Approved Investment Rule up to a maximum nominal investment of 30% per name subject to a long-term credit rating of AA.

8.2 The Director of Resources reviews the performance of the fund manager at least monthly.

8.3 The fund managers only make short-term investments as the liquidity of the fund is of paramount importance currently. Long-term investments are outside of the fund manager's current parameters. Therefore no limits have been set for long-term investments but this will be considered if required in the future.