

Report to: **Cabinet**

Date: **8 June 2004**

By: **Deputy Chief Executive and Director of Corporate Resources**

Title of report: **Update to Treasury Management Strategy for 2004/05**

Purpose of report: **To update the County Council's limits for borrowing in 2004/05, revise the maximum length of investments of surpluses and to amend the treasury management strategy and policy statement for 2004/05 accordingly.**

RECOMMENDATION -

The Cabinet is recommended to recommend the County Council to:

- (i) determine that for 2004/05 the authorised limit for borrowing shall be £287m;**
 - (ii) adopt the prudential indicators and limits within the report (as set out in the attached appendix);**
 - (iii) agree the revised Treasury Management Strategy and policy statement for 2004/05 (as set out in section 4 of the attached appendix)**
-

1. Financial Appraisal

1.1 This report contains recommendations about the borrowing limits the prudential indicators and limits and strategy and policy changes. The changes proposed in this report will assist in providing Best Value in the Councils' treasury management activities.

2. Supporting Information

2.1 East Sussex County Council defines its treasury management activities as the management of the organisation's cash flows, its banking, money market and capital market transactions (other than those of the Pension Fund), the effective management of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

2.2 In previous years, Cabinet has received a report to recommend to the County Council the borrowing limit, agree any required changes to the Treasury Management Policy Statement and Strategy and agree changes to the list of approved organisations used for short term investment. The latest guidance under Section 15 (1) (a) of the Local Government Act 2003 is that the Investment Strategy should be approved by the full Council.

2.3 The Treasury Management Strategy for 2004/05 was originally submitted to Cabinet on 27 January 2004. There have been a number of changes since the Strategy was agreed, including new guidance and information about local government investments, a significant additional borrowing approval for roads maintenance following the hot, dry 2003 summer and greater clarity about the new Prudential Code. It is appropriate to update the Treasury Management Strategy for 2004/05 in the light of these changes and the new freedoms associated with them.

2.4 The key driver remains the prudent approach to treasury management taken by this authority. The key issues continue to be to maximise the interest received on investments and minimise interest on borrowing, while conforming with best practice and minimising risk.

The attached appendix sets more detailed background information.

Operational and Authorised limits for borrowing

2.5 The background information and the calculation of the revised limits for 2004/05 of £268m (Operational) and £287m (Authorised) are set out in the attached appendix (paragraphs 1 and 2).

Prudential indicators and limits for Treasury Management

2.6 These are self-imposed prudential indicators and limits that are set on an annual basis. The indicators which relate to treasury management are set out in paragraph 3 of the appendix revised as necessary.

Changes to the list of organisations used for short term investment

2.7 The background information is set out in paragraphs 4.4 to 4.7 of the appendix. The risk attached to lending to other local authorities is minimal. The limits for local authorities are currently half of the other organisations used for short time investments but there is no difference in the risk. An increase to £20m. per authority is recommended in line with other organisations.

Changes to the investment of surpluses for a period of up to five years

2.8 The current policy ensures that money is only lent to institutions of the highest quality and limits the total sum which can be lent to any one of those organisations. The current strategy only allows for investments of up to one year and this may have been restricting the interest gained as longer term investments usually increase the return. The Local Government Investments Guidance has been issued since the original Strategy report was agreed. The new guidance allows investments for more than one year and it would be opportune in certain specific circumstances (as set out in the appendix), to allow longer term investments of over one year and up to five years. The current policy where only institutions of the highest quality are used and limits are set for these organisations will be maintained whether or not the investment is for under or over one year. The list of banks will continue to be regularly monitored to ensure that their financial strength and low risk has been maintained.

Treasury management strategy and policy statement for 2004/05

2.9 The original strategy and the policy statement for 2004/05 remain virtually unchanged and are set out in paragraph 4 of the attached appendix.

SEAN NOLAN

Deputy Chief Executive and Director of Corporate Resources

Contact Officers: *Richard Hemsley* Tel No. 01273 481820

Les Langston Tel No. 01273 481851

BACKGROUND DOCUMENTS

Cabinet – 28 May 2002 Agenda Item No 12b Treasury Man't- Updated Strategy report for 2002/03

Cabinet – 27 January 2004 Treasury Management Strategy for 2004/05

CIPFA Treasury Man't in the Public Services Code of Practice and cross sectional guidance notes
Prudential Code for Capital Finance 2004

Local Government Investments – guidance from Office of Deputy Prime Minister.

1. Background information

1.1 The Treasury Management Strategy for 2004/05 was submitted to Cabinet on 27 January 2004. There have been a number of changes since the report was agreed, including significant new guidance and information. The new guidance and information received includes:

- An unexpected borrowing approval related to repairing damage to roads caused by the dry hot summer of 2003 (which highlighted the need to add contingency headroom to the borrowing limits for supplementary approvals);
- Revised guidance (final version) on Local Government Investments;
- Greater clarity on the Prudential Code;
- A review by our Treasury Management advisors (which confirmed the interpretation on the same issues).

It is appropriate to reassess and update the strategy for 2004/05 in the light of this new information.

2. Authorised Limit for borrowing in 2004/05

2.1 The Authorised Limit determined for 2004/05 will be the statutory limit determined under section 3(1) of the Local Government Act 2003. There are two reasons to revise the original limit.

A. Additional 'In – Year' Credit Approvals

2.2 Since the original Authorised Limit was agreed by Cabinet in January, an additional borrowing approval has been granted which would breach the original limit. This has highlighted the need to allow some headroom in the limit for these circumstances. It would still be for the Authority to decide whether or not to undertake the additional borrowing but if so minded this could be done without having to increase the limits (which requires full Council approval).

B. Matching Financing Requirement to Capital Spending Plans

2.3 Until April 2004, when the new Prudential Code took effect, the amount which an Authority could borrow in total, and in any one year, was determined by Section 45 of Part IV, of the Local Government and Housing Act 1989 ("the Act").

2.4 In effect, the Act meant that even though Authorities were producing a medium term plan of their capital spending (a 3 or 4 year programme) they were forced to take an annual approach to any borrowing needed to finance that capital spending. For many Authorities, including the County Council, this meant that once the annual borrowing limit was reached no further borrowing was possible, however favourable interest rates may have been, until the new financial year. This meant that proactive management, borrowing for known need, when interest rates were favourable but about to rise, was often not possible.

2.5 The Prudential Code recognises the deficiencies of this aspect of the previous system and now allows capital borrowing to be planned over the same timescale as capital spending. The code states:

"In order to ensure that over the medium term net borrowing will only be for a capital purpose, the local authority should 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 the current and next two financial years".

The revised limits set out later in this report have been based upon the amount of capital spending to be financed through borrowing in the current and next financial year. Whilst the Prudential Code would allow a higher limit than this (current and next two financial years) it is considered

prudent at this stage to base the limits upon 2 years (current and next). This flexibility will overcome the restrictions of the current approach without allowing borrowing too far ahead of the financing requirement.

2.6 For 2004/05 it is estimated that the revised Authorised Limit for borrowing should be determined as:

		£m.
	Estimated borrowing at 1 st April 2004	217
Add	Borrowing to support capital programme	29
Add	Contingency headroom for supplementary approvals (£5m to date)	10
Less	Planned repayments of debt	<u>-9</u>
		247
Add	Estimated requirement for 2005/06	21
Add	Short term borrowing	<u>19</u>
	Authorised limit for borrowing 2004/05	<u>287</u>

3. Prudential indicators and limits

3.1 There are self-imposed prudential indicators and limits that are set on an annual basis. The indicators which relate to treasury management are included below:

- Operational and authorised borrowing limits (which also include short term borrowing) (see paragraphs 3.2 and 3.3 below) **updated since previous report**
- Interest rate exposures (see paragraph 3.4 below) **updated since previous report**
- Maturity structure of debt (see paragraph 3.5 below) **updated since previous report**
- Maturity structure of investments (see paragraph 3.6 below) **updated since previous report**

There are also a number of indicators which relate specifically to the authority's capital investment plans. Although these would not normally be included within this report, the impact on the treasury management limits caused by the notification of additional borrowing apply equally to these other indicators. These are:

- The capital programme
- The capital financing requirement
- The ratio of financing costs to net revenue stream
- The incremental impact on band D council tax

Operational and Authorised limits for borrowing

		2003/04 Projected Outturn £m	2004/05 Estimate £m	2005/06 Estimate £m	2006/07 Estimate £m
	Borrowing as at 1 April	196	217	247	268
ADD	Borrowing to support capital programme	26	29	16	14
ADD	Contingency headroom for supplementary approvals	0	10	15	15
LESS	Provision for repayments of debt	<u>-5</u>	<u>-9</u>	<u>-10</u>	<u>-10</u>
		217	247	268	287
ADD	Estimated net borrowing for next year	<u>0</u>	<u>21</u>	<u>19</u>	<u>20</u>
	Operational Limit	217	268	287	307
ADD	Short term borrowing	18	19	20	23
	Authorised Limit	<u>235</u>	<u>287</u>	<u>307</u>	<u>330</u>

3.2 The proposed Operational Limit for borrowing is based on the same estimates as the Authorised Limit without the additional amount for short term borrowing included to allow, for example, for unusual cash movements. The Operational Limit represents a key management tool for in year monitoring and long term borrowing control.

3.3 The authorised limits are consistent with the Council's current commitments, existing plans and the proposals for capital expenditure and financing, and with its approved treasury management policy statement and practices, they will be updated annually. They are based on the estimate of the prudent but not worst case scenario, with in addition sufficient headroom (short term borrowing) over and above this to allow for day to day operational management, for example unusual cash movements or late receipt of income. Risk analysis and risk management strategies have been taken into account as have plans for capital expenditure, estimates of the capital financing requirement and a headroom for supplementary approvals and estimates of cash flow requirements for all purposes.

3.4 Interest rate exposure

The Council will continue the current practice of seeking to secure competitive fixed interest rate exposure. To provide flexibility however it is proposed to set limits on our variable rate exposure in case that becomes a more effective approach. There are now figures for both borrowing and lending and a combined borrowing and lending table.

<u>Borrowing</u>	2003/04 Projected <u>Outturn</u>	2004/05 <u>Estimate</u>	2005/06 <u>Estimate</u>	2006/07 <u>Estimate</u>
Fixed Rate Exposure				
Upper Limit	100%	100%	100%	100%
Lower Limit	100%	81%	76%	71%
Variable Rate Exposure				
Upper Limit	0%	19%	24%	29%
Lower Limit	0%	0%	0%	0%
 <u>Lending</u>	 2003/04 Projected <u>Outturn</u>	 2004/05 <u>Estimate</u>	 2005/06 <u>Estimate</u>	 2006/07 <u>Estimate</u>
Fixed Rate Exposure				
Upper Limit	100%	100%	100%	100%
Lower Limit	0%	0%	0%	0%
Variable Rate Exposure				
Upper Limit	100%	100%	100%	100%
Lower Limit	0%	0%	0%	0%

<u>Borrowing and Lending combined</u>	2003/04 Projected <u>Outturn</u>	2004/05 <u>Estimate</u>	2005/06 <u>Estimate</u>	2006/07 <u>Estimate</u>
Fixed Rate Exposure				
Upper Limit	100%	100%	100%	100%
Lower Limit	67%	54%	51%	47%
Variable Rate Exposure				
Upper Limit	33%	46%	49%	53%
Lower Limit	0%	0%	0%	0%

3.5 Maturity structure of debt

The Council has set upper and lower limits for the maturity structure of its borrowings as follows.

	<u>Lower limit</u>	<u>Upper limit</u>
Under 12 months	0%	25%
12 months and within 24 months	0%	25%
24 months and within 5 years	0%	25%
5 years and within 10 years	0%	50%
10 years and above	50%	100%

3.6 Maturity structure of investments – Investment of surpluses for a period of up to 5 years.

Under the new Investment Guidance issued by the Officer of Deputy Prime Minister, local authorities have been allowed the freedom to invest for more than for one year. For this authority it will be appropriate to amend the current policy to take advantage of this freedom. It would be opportune to allow investments of over one year and up to five years. The current policy where only institutions of the highest quality are used and limits are set for these organisations will be maintained whether or not the investment is for under or over one year. The list of banks will continue to be regularly monitored to ensure that their financial strength and low risk has been maintained. Under the new Investment Guidance, all investments over one year would be classified as Non-Specified Investments and a limit of the amount that can be held within this category at any time during the year should be set. Any investments made of over one year will match the County Council's policies.

For example, investment of the Waste reserve where the balances can be lent out for a known period before being required, as set out below.

Year invested	Opening balance	Maximum amount invested over 364 days and up to 5 years	Closing balance
	£m.	£m.	£m.
2004/05	0	19	19
2005/06	19	8	27
2006/07	27	9	36
2007/08	36	5	41
2008/09	41	5	46

3.7 The 5 year capital programme

The actual capital expenditure that was incurred in 2002/03 and the estimates of capital expenditure to be incurred for last year and the current and future years that are recommended for approval are:

Capital Expenditure					
	2002/03 £000 Actual	2003/04 £000 Estimate	2004/05 £000 Estimate	2005/06 £000 Estimate	2006/07 £000 Estimate
Chief Executives	473	285	213	0	2,000
Corporate Resources	1,587	5,192	6,924	1,540	1,670
Education and Libraries	19,813	26,350	29,701	13,108	2,400
Social Service	745	2,139	1,819	6,520	495
Transport and Environment	15,202	12,964	20,622	13,865	9,101
Future schemes not yet identified				1,011	5,588
Total	37,820	46,930	59,279	36,044	21,254

3.8 Capital financing requirement

Estimates of the end of year capital financing requirement for the authority for last year and the current and future years are:

Capital financing requirement			
31/03/04 £m Estimate	31/03/05 £m Estimate	31/03/06 £m Estimate	31/03/07 £m Estimate
217	237	243	247

The Capital financing requirement excludes the contingency for supplementary approvals which is included in the Operational and Authorised Limits (paragraph 3.1).

The capital financing requirement measures the authority's underlying need to borrow for a capital purpose. In accordance with best professional practice, East Sussex County Council does not associate borrowing with particular items or types of expenditure. The Council has an integrated treasury management strategy and has adopted the CIPFA *Code of Practice for Treasury Management in the Public Services*. The Council has, at any point in time, a number of cashflows both positive and negative, and manages its treasury positions in terms of its borrowings and investments in accordance with its approved treasury management strategy and practices. In day to day cash management, no distinction can be made between revenue cash and capital cash. In contrast, the capital financing requirement reflects the Council's underlying need to borrow for a capital purpose.

3.9 Ratio of financing costs to net revenue stream

Estimates of the ratio of financing costs to net revenue stream for last year, the current and future years, and the actual figures for 2002/03 are:

Ratio of financing costs to net revenue stream					
	2002/03 Actual	2003/04 Estimate	2004/05 Estimate	2005/06 Estimate	2006/07 Estimate
	4.26%	4.02%	4.07%	4.14%	4.16%

3.10 The impact on band D Council Tax

The incremental impact of capital investment is as follows:-

For the Band D Council Tax

<u>2004/05</u>	<u>2005/06</u>	<u>2006/07</u>
£2.96	£12.10	£19.35

This represents the cumulative impact of the new starts proposed for 2004/05, 2005/06, and 2006/07.

4. Treasury Management Strategy and Policy Statement

4.1 On 28 May 2002, the Cabinet accepted the amended Treasury Management Policy Statement for 2002/03 and set out the framework for Treasury Management Practices. This formally brought East Sussex County Council in line with the Code of Practice for Treasury Management in Public Services. The Treasury Management Practices require the Deputy Chief Executive and Director of Corporate Resources to submit a report to the full Council annually on the treasury management strategy covering proposed activities for the financial year. This provides the Cabinet with the opportunity to consider the particular factors relevant to its own borrowing and lending requirements during the year.

4.2 An annual stewardship report on the latest borrowing and lending transactions undertaken since the previous report, including the economic climate and interest rate conditions prevailing over the period is contained elsewhere on today's Agenda.

4.3 The strategy will take account of the current economic scene and the current and forecast levels of interest rates. The main points of the advice received on interest rates for 2004/05 (unchanged from the previous strategy report) are:

- short term rates, currently standing at 3.75%, will increase to 4% before the start of the new year and are likely to increase to 4.5% by the end of 2004/05.
- long term interest rates will be 0.7% higher than the average rate in this current financial year (4.8%). The estimated rate is, therefore, 5.5%.
- The advice received for the following years is that it is estimated that short term rates will increase to an average of 4.6% in 2005/06 and 4.8% in 2006/07 but decrease in 2007/08 to 4.5%.
- The average long term interest rates will be slightly higher at 5.6% in 2005/06 and 2006/07 but will reduce to 5.2% in 2007/08.
- the advice is subject to changes in the world and political climate which could alter the interest rates significantly.

Overall, the advice is that interest rates will rise over the next two years.

Changes to the list of organisations used for investment

4.4 It is necessary to continually review the amounts able to be lent to the approved organisations used for investment of short term surpluses. The definition of short term for this purpose is from 1 to 364 days.

4.5 In the last few years, there have been changes to the list of approved organisations used for investment of short term surpluses. A further change to the list of the approved organisations for investments will ensure that the Council is able to continue to invest in the best available rates consistent with low risk. The list of banks will continue to be regularly monitored to ensure that their financial strength and low risk has been maintained.

4.6 The risk attached to lending to other local authorities is minimal. The limits for local authorities are currently half of the other organisations used for short time investments but there is no difference in the risk. An increase to £20m. per authority (in line with the limit for banks) is recommended.

4.7 The list of organisations used for investment of surpluses is set out below.

- Permit lending up to £20m. to another local authority (currently £10m.)
- Permit lending up to £20m. to banks and building societies (with assets of over £20bn.) with a short term rating of P1 and a long term rating of at least A1
- Permit lending up to £5m. to banks and building societies (with assets of over £20bn.) with a short term rating of P2 and a long term rating of at least A1 but restricted to a period of not more than 6 months
- Permit lending up to £30m. to the Government Debt Management Account Deposit Facility
- Permit lending up to £10m. to one discount house
- Permit using an external fund manager for up to £30m.

(The ratings used are Moody's credit ratings and these are used world wide to gauge the financial viability and strength of organisation of potential investment institutions)

4.8 The strategy for 2004/05 should be to continue the aim of borrowing long term at the lowest rate available during the year, and for short term borrowing and lending to be at the best rates available consistent with low risk. Opportunities should be taken to restructure long term debt if and when they arise.

4.9 It is recommended that the Treasury Management Policy Statement for 2004/05 should be unchanged. The Statement is set out below

East Sussex County Council defines its treasury management activities as:

"The management of the organisation's cash flows, its banking, money market and capital market transactions (other than those of the Pension Fund), the effective management of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

The County Council regards the successful identification, monitoring and management of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.

This authority acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.