CABINET **25 MARCH 2004**

2004/5 TREASURY MANAGEMENT STRATEGY
(Report by the Head of Financial Services)

1. INTRODUCTION

1.1 The Council has adopted the CIPFA Code of Practice for Treasury Management as part of its Code of Financial Management. This requires an annual strategy statement to be prepared and this report therefore recommends the strategy for 2004/5

1.2 The prudential capital finance system comes into effect on 1 April 2004 and the Council agreed the prudential indictors at its meeting on 18 February 2004. The Prudential Code does not include guidance on investments and therefore the Secretary of State has published 'statutory' guidance which was not received until 12th March although it comes into effect from 1 April 2004. It requires each Authority to approve an Annual Strategy (which the Council already does). It recommends that this is approved by the full Council prior to 1 April each year, however in view of the late publication of the guidance, approval can be delayed beyond 1 April on this occasion.

2. BACKGROUND

2.1 At any moment the Authority's investments will consist of two distinct elements - cash flow and reserves. Cash flow is the day-to-day impact of managing the flow of funds into and out of the Council. For instance, the dates on which the County Council is paid its portion of the council tax will be different to the days the money is received from those living in the District. These cash flows will sometimes leave the Council with several million pounds to borrow or invest for a few days. The reserves are fairly stable in that there will be a definite estimate of the amount at the start and end of the relevant year but even this will fluctuate as a result of any variation in estimated interest rates and general under or overspending.

2.2 In recent years there have only been modest reductions in reserves due to the financing of capital expenditure being partially offset by contributions to revenue reserves and some underspending. However the new MTP approved by February Council shows major reductions in reserves over the coming five years as shown in the table below:

RESERVES	FORECAST	MTP				
	2003/ 2004	2004/ 2005	2005/ 2006	2006/ 2007	2007/ 2008	2008/ 2009
POSITION AT END OF YEAR (March)	**£M**	**£M**	**£M**	**£M**	**£M**	**£M**
	71	**58**	**39**	**24**	**16**	**13**

2.3 The amount currently with each Fund Manager is as follows:

Investec		£29m
Alliance Capital		£29m
Cash Deposit Cash Managers		£20m
	Total	**£78m**

2.4 There will be a need for the Fund Managers to return some funds to the Authority during 2004/5 to meet its cash flow requirements. The strategy is to reduce the funds of Investec and Alliance Capital equally.

2.5 Because cash flow is not an exact science, as there is no certainty as to when the cheques that are sent out on a particular day will be cleared and when income will be collected, it will normally be financially advantageous to have some delay before funds are returned which will increase the reliance on temporary borrowing to manage the process in the Council's best interests. It is expected that temporary borrowing will not exceed £7m at any one time, however the Council has approved the prudential indictor for the 'authorised limit for external debt' of £15m.

2.6 In the short-term, whilst the Authority holds substantial reserves, it is not imperative that the investment returns are maximised in any one year thus allowing a medium term approach to fund management to be taken. Thus an investment approach that accepts fluctuations between years in return for greater returns is possible. This in turn has an impact on the investment instruments the Council uses.

2.7 The fluctuating balance of the fund is managed internally to ensure that whilst sufficient sums are available on a daily basis to meet payments to creditors the investment return is maximised on those days where a surplus is held. Because of these constant fluctuations the majority of these sums are inevitably invested for short periods as time deposits with low risk counter-parties. Annex B outlines the mandate for the internal funds and lists the approved counter-parties though it should be noted that these will change during the course of any year as credit ratings or size of building societies change.

2.8 The Approved Investment Regulations (1990) allowed debt-free authorities to invest in a variety of instruments including 'non-approved' such as corporate bonds. The Authority's treasury management strategy made use of this freedom, and Alliance Capital in particular has shown that such a strategy can produce good returns. The new guidance on Local Authority Investments now categorises investments as 'specified' and 'non-specified':

- Specified investment:
  - o It is in sterling
  - o It is due to be repaid within 12 months
  - o It is not defined as capital expenditure in the capital finance regulations 2003
  - o It is with a body that has a high credit rating or it is made with the UK Government (i.e.gilts), or a local Authority

- Non-specified investments include all other types of investment. The draft regulations do not rule out any type but the Annual Investment Strategy must define which can be used

The guidance does not require or imply that a Council should make any change to the types of investments that it has been using.

2.9 The Council appointed Butlers as Treasury Management Advisors to assist in the choice of Fund Managers, develop the mandates and assist in monitoring the Managers' performance. This has been beneficial given the large sums invested, the complexity of the wider range of instruments used and the ability to compare performance with that achieved by other Fund Managers. CIPFA recommends, as part of the Code of Practice for Treasury Management, that the appointment of consultants be reviewed regularly. The Director of Commerce and Technology will tender for the treasury management consultancy service in 2004/5.

3. STRATEGY FOR 2004/5

3.1 The Council's investment funds will remain with the current three Fund Managers, subject to them achieving satisfactory investment returns. The level of investment risk and the range of investments to be used are encapsulated in the existing mandates (Annex A). There will be no significant increase in the level of investment risk but some minor variations may be required during the course of the year. .

3.2 The guidance states that the Annual Investment Strategy should identify certain matters. Most of these are addressed as part of the mandates. However for clarification they are identified below.

(a) **Specified investments**. A definition of 'high credit rating' for specified investments (see paragraph 2.8): the mandates confirm a short-term rating of at least F1.

(b) The frequency that credit ratings are monitored: Butlers monitor the credit ratings of banks and building societies and notify your treasury management staff of any changes immediately. Unless the Authority is notified of a variation, it is assumed that the credit rating has not changed. Where a credit rating is downgraded that bank or building society can be removed from the counter-party list immediately.

(c) **Non-specified investments**. The procedure for determining the categories of non-specified investments: Members approve the Annual Strategy that sets out the classes of investment and these are reviewed during the year with the Capital Receipts Advisory Group, the consultant and the Fund Managers.

(d) The categories of non-specified investments that can prudently be used during 2004/5: these are identified in the mandates for the Fund Managers, but may be subject to change when the ODPM issues its final guidance.

(e) The maximum amounts that can be held in each category, as a percentage of the total portfolio managed by each Fund Manager or as a sum of money: the limits are given in the mandates.

(f) **Liquidity of investments.** The time deposits managed by CDCM are the least liquid investments and their mandate specifies the maximum period for which funds may prudently be committed. The investments managed by Alliance Capital and Investec are all highly liquid. The procedure to ensure that there are sufficient funds to meet the cashflow needs of the Authority, is for officers to review the mandates of the Fund Managers with the Capital Receipts Advisory Group (see paragraph 3.4).

(g) The minimum amount that is held in 2004/5 in investments that are not long-term (over 1 year). This will be £38m

3.3 The funds managed internally will continue to be minimised and will normally only cover the day-to-day variations in cash flow. Investments will be made in accordance with Annex B.

3.4 Your officers will discuss with the Capital Receipts Advisory Group the approach to be taken to balance reduced investment levels over the next five years with the achievement of reasonable returns on the remaining investments. They will need to consider varying the level of funds invested with each Fund Manager, narrowing of the mandates, reducing or changing the Fund Managers and modifying the approach on the level of funds managed internally.

3.5 Temporary borrowing will be restricted to that necessary for:

- cash flow,
- the cost effective staged return of our investments as they are needed to finance Council spending over the coming five years,
- taking advantage of situations and where interest rate levels make it beneficial to invest sums for longer than cash flow projections, suggest they will be available subject to there being no, or minimal risk in so doing.

3.6 The Council approved the prudential indicator for the ‘authorised limit for external debt’ of £15m, and the ‘operational boundary for external debt’ of £7m, at its meeting on 18 February 2004.

3.7 The Director of Commerce and Technology will tender for treasury management consultancy services during 2004/5.

3.8 The Director of Commerce and Technology, supported by the consultant, will continue to consult with the Capital Receipts Advisory Group, to monitor the performance of the funds and to raise any issues and concerns with the Fund Managers.

3.9 The Cabinet will receive quarterly reports on the performance of the funds and an annual report on the performance for the year.

3.10 The strategy is not intended to be a strait-jacket but a definition of the general approach that is intended for the current year. Minor changes that are broadly consistent with this strategy are delegated to the Head of Financial Services, after consultation with the Capital Receipts Advisory Group in certain cases. Any proposal for significant change to this strategy will be referred back to Cabinet.

4. RECOMMENDATION

4.1 Cabinet is requested to recommend to Council that it approves this Strategy.

BACKGROUND PAPERS:
Background files in Financial Resources Section
2003/04 Strategies
Reports on the 2004/05 Budget and Medium Term Plan to Cabinet and Council
CIPFA's Treasury Management in the Public Services Code of Practice 2002
ODPM Draft Guidance on Local Government Investments December 2003

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ANNEX A

EXTERNAL FUND MANAGER MANDATES

Alliance Capital and Investec

Duration of investments	Average duration of Fund must not exceed 3 years No individual investment shall exceed 10 years
Types of investments	Marketable securities issued or guaranteed by the UK Government **(Gilts)** Deposits made with or marketable certificates of deposit issued by approved banks **(CDs)** Sovereign and supranational securities, including floating rate notes **(Bonds)** Corporate, bank and building society securities, including floating rate notes, commercial paper and asset backed securities **(Corporate Bonds)**
Credit Ratings	**CORPORATE INVESTMENTS** Standard & Poors AA- or Aa3 or above or equivalent A- or A3 or better, maximum term 3 years **NON-UK GOVERNMENTS AND SUPRANATIONALS** AA- or Aa3 or above or equivalent for non-UK Governments AAA or Aaa for Supranationals **SHORT-TERM INVESTMENTS** Standard & Poor's A1/P1 or above or equivalent
Maximum limits	40% Corporate Bonds 20% Supranational and sovereign securities 40% Floating rate notes 75% Gilts 75% Corporate Bonds plus Gilts 50% Corporate bonds + supranational and sovereign securities + floating rate notes 20% with any one counterparty (except UK Government) for fixed deposits and CDs 10% per issuer or £1m for corporate bonds and FRNs 10% per issuer for securities guaranteed by non-UK EU Governments and supranational securities
Benchmark	60% 3 month LIBID 40% 0-5 year gilt index.

CDCM

Duration of investments	Up to and including 5 years maximum maturity No more than 25% may be invested for longer than 3 years
Types of investments	Fixed Deposits Deposits at call, two or seven day notice
Credit Ratings	F1+ by FITCH IBCA or equivalent
Maximum limits	£3m per institution and group for English and Scottish Clearing Banks and their subsidiaries, and Overseas Banks on list of authorised counterparties. Building Societies With assets more than £2,000m £3m With assets more than £1,000m £2m Other building societies in the top 25 £1m
Benchmark	3 month LIBID

ANNEX B

INTERNAL FUND MANAGEMENT

Duration of investments	Fixed deposits up to and including 1 year
Types of investments	Fixed Deposits Deposits at call, two or seven day notice
Credit Ratings and Maximum limits	See below The credit rating is the short-term rating issued by FITCH unless otherwise indicated
Benchmark	LGC 7 day rate

COUNTER-PARTY LIST

LIMIT £2.5M	**SHORT TERM RATINGS**
BANKS (Rated F1)	
Abbey National plc	F1+
Alliance and Leicester	F1+
Barclays	F1+
Co-Operative	F1
HBOS	F1+
HSBC	F1+
Kleinwort Benson	P1*
Lloyds TSB Group	F1+
Northern Rock	F1
Royal Bank of Scotland	F1+
BUILDING SOCIETIES (Assets over £5 billion – Rated F1 or better)	
Britannia	F1
Coventry	F1
Nationwide	F1+
Portman	P1*
Yorkshire	F1
ALL LOCAL AUTHORITIES, POLICE AND FIRE AUTHORITIES	N/A

* Moody's credit rating

LIMIT £1.5M	SHORT TERM RATINGS
BANK SUBSIDIARIES Wholly owned by F1 Rated banks	
RBS Trust Bank Ltd	F1+
Ulster Bank Limited	A1**
Ulster Bank Ireland	A1**
OTHER BANKS	
Bank of Ireland	F1+
Bank of Scotland (Ireland)	F1+
Bristol and West	F1
Close Brothers	F1
DePfa Bank	F1+
Dexia Banque Internationale a Luxembourg	A1+**
Hamburgishe Landesbank	F1+
HFC Bank	F1
Irish Intercontinental Bank	F1
KBC Bank NV	F1+
Singer and Friedlander	F1
OTHER INSTITUTIONS Rated F1	
3i Group Limited	A1**
Irish Life and Permanent plc	F1
BUILDING SOCIETIES (Assets over £2 billion)	
Chelsea	
Cheshire	
Cumberland	
Derbyshire	
Leeds and Holbeck	
Newcastle	
Norwich and Peterborough	
Principality	
Scarborough	
Skipton	
West Bromwich	

LIMIT £1M	SHORT TERM RATINGS
BUILDING SOCIETIES (Assets over £1.5 billion)	
Dunfermline	
Nottingham	
Staffordshire	
Stroud and Swindon	

** Standard and Poor's credit rating
Standard & Poors AA- or Aa3 or above or equivalent