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CABINET **2 FEBRUARY 2006**

2006/07 TREASURY MANAGEMENT STRATEGY
(Report by the Head of Financial Services)

1. INTRODUCTION

1.1 A Treasury Management Strategy will ensure that the Authority has clear objectives for the management of its borrowing and investments. It is also needed to comply with the Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice, which is required by the Council's Code of Financial Management. The Government has also published Guidance which recommends that an Annual Investment Strategy is produced each year and approved by the full Council.

1.2 The Guidance emphasises that priority must be given to the security and liquidity of investments whilst the Code covers the same point by requiring the effective management and control of risk. This Strategy is intended to meet the requirements of the Code and the Guidance.

1.3 The proposed strategy is attached as an annex.

2. RECOMMENDATION

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

BACKGROUND PAPERS:
Background files in Accountancy Section: Treasury Management Reports
Reports on the 2006/7 Budget and Medium Term Plan to Cabinet and Council
CIPFA's Treasury Management in the Public Services Code of Practice 2002
ODPM Guidance on Local Government Investments March 2004

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ANNEX

TREASURY MANAGEMENT STRATEGY 2006/07

This Treasury Management Strategy is intended to meet the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice and the Government's Guidance on Local Government Investments.

CASH FLOW

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 and is dealt with in-house. 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.

Reserves are more stable in that there will be a definite estimate of the amount that they will reduce or increase by during the course of the year but even this will fluctuate to some extent as a result of any variation in inflation, interest rates or general under or overspending.

CURRENT POSITION

Most investment activity is carried out by the Council's three fund manager's who currently manage the following sums:

Investec	£26.5m
Alliance Capital	£26.5m
City Deposit Cash Managers	£20m
Total	**£73m**

MANAGING THE REDUCTION IN RESERVES

In recent years there have only been modest reductions in reserves due to their use for financing revenue and capital expenditure being partially offset by capital receipts, underspending and delays. However the draft MTP that will be considered by Council in February shows major reductions in reserves over the coming five years as shown in the table below:

RESERVES	MTP					
	2005/ 2006	2006/ 2007	2007/ 2008	2008/ 2009	2009/ 2010	2010/ 2011
	£M	**£M**	**£M**	**£M**	**£M**	**£M**
Forecast position at end of year	**56**	**42**	**24**	**12**	**10**	**8**

Investec and Alliance Capital both utilise a broader and more volatile range of investments. As the amount of investments reduces, the strategy is to take funds equally from these two managers until the point is reached where there is insufficient to warrant two separate funds. At that point a judgement of which manager to retain will be made in consultation with the Capital Receipts Advisory Group and the Council's advisor. Subsequently, as funds reduce further, the point will be reached where City Deposit Cash Managers or an equivalent manager looks after the whole fund that concentrates on a narrower more stable type of investments. Based on past experience there is some likelihood of spending delays during the next 14 months and so it is likely that there will still be three fund managers in March 2007.

Your officers will liaise with the Capital Receipts Advisory Group and the Council's advisor to ensure that where and when appropriate mandates will be narrowed (e.g. duration reduced, credit ratings increased or instruments deleted).

LONG-TERM BORROWING

As the Council's reserves run out, as illustrated in the table above, there will be a need for long-term borrowing to finance the capital programme. The financial plan shows that this will not be until 2008/9 however efficient treasury management involves borrowing when interest rates are judged to be at the best level, even if the funds have then to be invested at at least the same rate until the money is required; borrowing in this way is allowed if it is for planned expenditure.

If the interest rates are judged to be at the best level during 2006/7, a maximum of £10m will be borrowed for a period of 25 years or longer. Before any long-term borrowing is undertaken, advice will be taken from our treasury management advisor, and the Executive Councillor for Finance will be consulted.

IN-HOUSE MANAGEMENT

The Fund Managers will be asked to return funds to the Authority as and when they are needed. There are significant changes in cash flow on a daily basis which could result in the Authority moving from having funds to invest to a position of having to borrow. However it will normally be financially advantageous to have some delay before funds are returned thus minimising the need for in-house investment activity, this 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 normally exceed £15m at any one time.

The Council will need to approve a prudential indicator for the 'authorised limit for external debt'; this combines temporary and long-term borrowing and a maximum of £30m is being recommended.

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. Appendix A 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.

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,

- taking advantage of situations 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.

CATEGORIES OF INVESTMENT

The guidance on Local Authority Investments categorises investments as 'specified' and 'non-specified':

Specified investment:

- It is in sterling
- It is due to be repaid within 12 months
- It is not defined as capital expenditure in the capital finance regulations 2003
- 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.

This differentiation requires the types of non-specified investments that will be used to be defined in the Annual Investment Strategy.

Money Market Funds (MMFs)

MMFs are instruments for managing short-term cash based on pooling investments from organisations such as Local Authorities and reinvesting them in larger blocks with a range of counterparties with high credit ratings (AAA or A1/P1).

The MMF aggregates its returns and, after deducting its management costs, pays out an average rate to investors. Experience has shown that the return is usually equal to or better than the rates obtainable elsewhere for small or short term sums.

Investec wish to use MMFs because the number of high quality counterparties has reduced during 2005 and this will give them extra flexibility at no added risk to the Council. They are also a potential advantage for in-house funds. The mandates in Appendices A and B have been therefore been amended to include the use of MMFs where credit ratings are no lower than required for other instruments.

INVESTMENT INSTRUMENTS USED BY THE COUNCIL

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.

The previous regulations allowed debt-free authorities, like Huntingdonshire, to invest in a wide variety of instruments including corporate bonds, and the treasury management strategy made use of this freedom with resulting higher but fluctuating returns; no change is proposed to this general approach during 2006/07.

The previous regulations required the Fund Managers to act as advisors when purchasing corporate bonds and similar securities, and the Council Officers had to approve the purchase. The Council continued this arrangement for the purchase of non-specified investments, however during 2005/06 this was changed, after taking advice from our advisor, so that the Fund Managers do not need approval to buy non-specified investments.

ADVISORS

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. A tendering exercise was carried out in 2004/05 for the appointment of an Advisor, and Butlers was reappointed until December 2007.

FUND MANAGERS

The Council's investment funds will remain with the current three Fund Managers, subject to them achieving satisfactory investment returns and subject to reductions in reserves not being required sooner than planned. The level of investment risk and the range of investments to be used are covered in the existing mandates However Alliance Capital has requested that their mandate is amended in two ways:

(a) The % of the portfolio that can be invested in AA- or Aa3 securities is increased from 40% to 50%.
(b) The inclusion of perpetual securities

Our advisor considers that these changes do not increase the risks to the fund and therefore the mandate in Appendix B incorporates these changes. They will also apply to Investec.

KEY POINTS

The Government Guidance recommends that certain aspects are highlighted. Most of these are covered within the mandates but they are listed below for convenience:

Definition of 'high credit rating' for specified investments
A short-term rating of a minimum of F1.

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.

The procedure for determining the allowed categories of non-specified investments
Council approve the Strategy that sets out the allowed categories and relevant constraints. These are kept under review during the year by your officers, the Capital Receipts Advisory Group and Butlers (the Council's professional advisor).

The categories of non-specified investments that can prudently be used during 2006/07
These are identified in the mandates at Appendix B.

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
These are identified in the mandates at Appendices A and B.

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 maintain cash flow forecasts and to review the mandates of the Fund Managers with the Capital Receipts Advisory Group.

The minimum amount that will be held in 2006/07 in investments that are not long-term (over 1 year)
This will be £22m.

MANAGEMENT
The Director of Commerce and Technology and his staff, supported by the Council's professional advisor, together with the Capital Receipts Advisory Group, will monitor the performance of the funds and raise any issues and concerns with the Fund Managers.

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

GENERAL
The strategy is not intended to be a strait-jacket but a definition of the upper limit of the level of risk that it is prudent for the Council to take in maximising its borrowing and investment activities during 2006/07. Any minor changes that are broadly consistent with this Strategy and either reduce or only minimally increase the level of risk, are delegated to the Head of Financial Services, after consultation with the Capital Receipts Advisory Group in certain cases. Any other proposal to change this strategy will be referred back to the Council.

The Council's Prudential Indicators, which are an annex to the Budget Report, set various limits that are consistent with this Strategy and allow officers to monitor its achievement.

APPENDIX A

IN-HOUSE 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 Money Market Funds
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	
Anglo-Irish	F1
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+**
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	
Derbyshire	
Dunfermline	
Leeds and Holbeck	
Newcastle	
Norwich and Peterborough	
Nottingham	
Principality	
Skipton	
Stroud and Swindon	
West Bromwich	

LIMIT £1M	SHORT TERM RATINGS
BUILDING SOCIETIES (Assets over £1.5 billion) Scarborough	

** Standard and Poor's credit rating

APPENDIX B

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)** Money Market Funds **(MMFs)**
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 **MONEY MARKET FUNDS** AAA
Maximum limits	50% Corporate Bonds 20% Supranational and sovereign securities 50% 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