

Prudential Indicators and Treasury Management Strategy

The Prudential Code and Prudential Indicators

Introduction

This budgetary cycle provides for the second full year of the operation of the CIPFA Prudential Code. The Prudential Code uses prudential indicators to highlight particular aspects of capital expenditure plans. Each indicator provided during the 2004/05 budget process has been updated and provided for the next three years. These are shown below. The Council approves as a minimum certain mandatory prudential indicators.

The purpose of the indicators is to provide a framework for capital expenditure decision making. The prudential indicators indicate the level of capital expenditure, the impact on borrowing and investment levels and the overall controls in place to ensure the activity remains *affordable, prudent and sustainable*.

Within this overall capital expenditure framework there is a clear impact on the Council's treasury management activity, either through increased borrowing levels or the application of investment balances. As a consequence the treasury management strategy for 2005/06 is included in this Appendix, which incorporates the relevant treasury management prudential indicators and the annual investment strategy required under guidance issued by the ODPM.

Capital Expenditure and the Capital Financing Requirement

The Capital Financing Requirement (CFR) represents the Council's underlying need to borrow for a capital purpose, and the change year on year will be influenced by the capital expenditure plans contained elsewhere within this Budget Report.

A certain level of capital expenditure will attract government support through housing subsidy or revenue support grant. Expenditure above this level is unsupported and will be limited by affordability in terms of the revenue consequences. In addition, Government retains powers to restrict at either a national and/ or local level the level of expenditure and borrowing undertaken by local authorities.

The Council's expectations for the CFR over the next three years are shown in the table below, with the associated capital expenditure plans (split between housing and non-housing), financing, and the expected external debt for each year.

	2003/04 Actual £'000s	2004/05 Updated £'000s	2005/06 Estimated £'000s	2006/07 Estimated £'000s	2007/08 Estimated £'000s
Capital Expenditure					
<i>Non Housing spend</i>	5,883	6,272	9,849	5,335	1,169
<i>Housing spend</i>	9,218	10,120	8,888	8,594	8,594
<i>Total spend</i>	15,101	16,392	18,737	13,929	9,763
Financed by:					
<i>Borrowing</i>	-				
<i>Capital receipts</i>	5,958	7,020	5,333	5,936	2,620
<i>Capital grants</i>	2,765	2,306	2,395	1,012	179
<i>Capital Reserves</i>	4,878	6,102	9,007	5,031	5,014
<i>Revenue Contribution</i>	1,500	200	1,200	1,200	1,200
Capital Financing Requirement					
CFR – Non Housing	2,974	2,974	2,974	2,974	2,974
CFR - Housing	-8,221	-7,457	-6,655	-5,905	-5,155
Total CFR	-5,247	-4,483	-3,681	-2,931	-2,181
<i>Net movement in CFR</i>	-	764	802	750	750
External Debt*					
Total Debt at 31 st March	20,500	17,500	14,500	11,500	8,500
Investments	(32,770)	(30,000)	(28,000)	(26,000)	(23,000)
Net Investments at 31 st March	(12,770)	(12,500)	(13,500)	(14,500)	(14,500)

A risk inherent within these plans is the uncertainty over future levels of government support. In addition a substantial proportion of funding is expected from the sale of assets. Delay or fluctuations in values may impact on the required borrowing and/or result in capital expenditure plans being revised.

Limits to Borrowing Activity

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 2005/06 and next two financial years.

The Finance Director reports that the Council has complied with the requirement to keep net borrowing below the relevant CFR in 2003/04, 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.

A further two Prudential Indicators control the overall level of borrowing, including items classified as other long term liabilities in accordance with legislation and/ or proper accounting practices. The first is the **Authorised Limit**, which represents the limit beyond which borrowing is prohibited. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. (*This is the statutory limit determined under section 3 (1) of the Local Government Act 2003*). The second limit is the **Operational Boundary**, and reflects the probable level of

external borrowing during the course of the year. Actual borrowing could vary around this boundary for short times during the year.

The following limits are proposed:

	2004/05 Comparator £'000s	2005/06 Estimate £'000s	2006/07 Estimate £000's	2007/08 Estimate £'000s
Authorised Limit	30,000	25,000	22,000	18,000
Operational Boundary	21,000	20,000	17,000	13,000

The above limits are set based on the Council's current strategy of reducing debt over the medium term. The Operational Boundary is set based on the actual profile of debt plus allowance for possible use of overdraft facilities. The Authorised Limit introduces an element of cover against the risks associated with realising capital resources assumed in the capital plans, and possible short-term cash flow requirement in the event of delayed revenue income or debt restructuring.

Affordability Prudential Indicators

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:

Actual and Estimates of the ratio of financing costs to 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.

Ratio of financing costs to net revenue stream

	2003/04 Actual	2004/05 Comparator	2005/06 Estimate	2006/07 Estimate	2007/08 Estimate
Non-HRA	0.28%	(1.87%)	(0.72%)	(0.74%)	(0.80%)
HRA	3.62%	4.03%	3.88%	4.01%	3.96%

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

The non-HRA ratio shows that following a number of rescheduling exercises in previous years the cost of residual debt is matched by investment returns. Net Financing cost to the HRA reflects the PWLB premia incurred on past rescheduling which is in fact being recovered through HRA subsidy. Taking this into account the HRA generates interest income on its balances (including set-aside receipts prior to the Pooling mechanism being introduced).

Estimates of the incremental impact of capital investment decisions on the Council Tax – This indicator identifies the trend in the cost of proposed changes in the three year capital programme recommended in this budget report compared to the Council's existing commitments and current plans. The forward assumptions are

based on the assumptions included in the budget, and include the opportunity cost associated with the use of capital resources.

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

	Proposed Budget 2005/06	Forward Projection 2006/07	Forward Projection 2007/08
Council Tax - Band D	£8.78	£22.10	£36.17

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 budget report compared to the Council’s existing commitments and current plans, expressed as a change in weekly rent levels. *(Note – under Rent Restructuring any change in revenue costs arising from the capital expenditure will be compensated for by a change in other costs).*

Incremental impact of capital investment decisions Housing Rent levels

	Proposed Budget 2005/06	Forward Projection 2006/07	Forward Projection 2007/08
Weekly Housing Rents	£0.99	£1.98	£2.99

Treasury Management Strategy 2005/06 – 2007/08

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 on 19 February 2003¹, and as a result adopted a treasury management policy statement.

The Policy requires an annual strategy to be reported to the Cabinet outlining the expected treasury activity for the forthcoming 3 years, and highlighting both the risks, and the management of those risks, associated with the treasury activities.

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

Current Treasury Position

At the end of the 2003/04 financial year the Council's total borrowing stood at £20.5m, comprised of £14.5m of PWLB debt and £6m of market loans. During 2004/05 a further £3m of PWLB will mature taking the balance of total debt to £17.5m. The whole of the PWLB debt is currently at an overall fixed rate of 4.6%. The market loans have a combined interest rate cost of 4.7% and contain a provision for this rate to be varied at the lender's discretion subject to the Council also having the option to repay at such time.

The level of investments at the end of the 2003/04 financial year was £32.77m. During the year the total sum invested averaged £41m and an overall return of 3.55% was achieved. In 2004/05 the average sum invested is expected to be a similar level, although with an upturn in rates the rate of return is expected to be around 4.7%. In future year the sums available for investment are likely to reduce in line with:

- o The natural maturity of debt
- o The application of earmarked reserves towards capital funding

¹ This is the first prudential indicator for treasury management representing a statement of good practice

The growth in sums invested has also been halted by the introduction of the housing capital receipt's pool.

The Council continues to employ an external cash fund manager to manage £20m of the total investment sum.

Expected Movement in Interest Rates

The Bank of England's November Inflation Report tended to support the view that the Monetary Policy Committee will be content to leave interest rates at their current level of 4.75%, although the possibility of one more hike to a peak of 5% cannot be ruled out entirely at this stage.

The report reflects a more benign picture for the UK economy, with a slow down in the housing market, and expectations of a deceleration in UK GDP growth. On the inflation front, the annual rate of increase in CPI is expected to rise to 2% two years hence and a little more thereafter. Some supply bottlenecks, higher energy prices and the adverse effects of currency depreciation are cited as principal reasons for this. Nevertheless, the Bank does not anticipate a marked pick-up in labour costs and points to the fact that some rise in manufacturing inflation is being countered by greater stability in the service sector.

The report does stress that there are a huge number of uncertainties overshadowing the domestic as well as international backdrop. While some of these could lead it resume a process of policy tightening the report concludes that *"the overall risks to growth and inflation are somewhat on the downside"*.

Against this backdrop the expected movement in interest rates are as follows:

Medium-Term Rate Forecasts

Percent	Base Rate	5-year Gilt	20-yr Gilt
2004/05	4.6	4.8	4.9
2005/06	4.6	4.7	4.8
2006/07	4.3	4.5	4.6
2007/08	4.8	5.0	5.1

Source: Butlers

Borrowing and Debt Strategy

Over the last few years the Council has actively restructured its loan portfolio, the most recent being carried out in October 2003. At present, capital expenditure plans are based on the assumption that the Council will not take on any new borrowing, instead funding the programme through the sale of assets. The current maturity profile of the debt portfolio provides opportunity to continue a steady reduction in the overall level of borrowing over the medium term. With an expectation of increases in borrowing cost, further opportunity to restructure/ prematurely repay debt will be considered where discounts may be possible.

Investment Strategy

The main principle governing the Council's investment criteria is the security and liquidity of its investments (i.e. safeguarding the principal sum and ensuring cash is

available when it is required) before yield (or return), although yield on the investment is a valid consideration. After this main principle the Council will ensure:

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.
- It maintains a policy covering the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security.

The Council recently approved this policy at its meeting on 22nd December 2004 under the item dealing with the Annual Investment Strategy for 2004/05. As there are no changes being proposed for 2005/06 or future years the policy has not been repeated in this document, but will continue to apply. In particular no changes are being made to:

- The definition of specified/ non-specified investment to be used by the Council.
- The criteria used for selecting suitable counterparties for investment purposes.
- Limits on investment types/ counterparties.

Expectations on shorter-term interest rates show a strong likelihood of remaining fairly stable as we move into 2005/06 and reductions coming in the second half of the year. The Council's investment decisions are based on comparisons between market rates and those predicted by the Council's own forecasts based on external advice. Where opportunities arise, longer-term investments may be considered in order to lock in good value and security of return. The Finance Director, under delegated powers, will undertake the most appropriate form of investments depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above.

For financial planning purposes an average return of 4.5% is assumed. Whilst this rate is felt achievable over the medium term, pressure on absolute returns may come from a reduction in the level of balances and reserves. Budget certainty would be enhanced by retaining benefits gained through outperformance in a particular year towards the equalisation of future investment returns.

Treasury Management Prudential Indicators and Limits on Activity

There are four treasury prudential indicators. 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 of borrowing decisions impacting negatively on the Council's overall financial position. However if these are set too restrictive they will impair the opportunity to reduce costs. The indicators are:

Upper limits on variable rate exposure – This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments.

Upper limits on fixed rate exposure – Similar to the previous indicator this covers a maximum limit on fixed interest rates.

Maturity structures of borrowing – These gross limits are set to reduce the Council’s exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

Total principal funds invested longer than 364 days – These limits are set to reduce the risk associated with early sale of an investment, and are based on the availability of investments after each year-end.

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.

The following indicators are proposed:

	2005/06	2006/07	2007/08			
	Upper	Upper	Upper			
Limits on fixed interest rates	100%	100%	100%			
Limits on variable interest rates	40%	50%	60%			
Maturity Structure of existing fixed borrowing						
	Lower	Upper	Lower	Upper	Lower	Upper
Under 12 months	0%	40%	0%	60%	0%	100%
12 months to 2 years	0%	40%	0%	50%	0%	N/A
2 years to 5 years	0%	30%	0%	N/A	0%	N/A
5 years to 10 years	0%	N/A	0%	N/A	0%	N/A
10 years and above	0%	N/A	0%	N/A	0%	N/A

The upper limits on fixed and variable rate exposure is based on the reducing levels of debt. The Council also retains a significant investment portfolio that provides a substantial hedge against the risk associated with variable rate exposure.

The upper limits on maturity structure reflect the natural maturity profile of existing debt that is gradually being paid off. With effect from 2008/09 the only debt will be £6m of market loans (subject to no decision being taken to prematurely repay). In the event of a change of strategy including use of prudential borrowing, any future new borrowing will be taken out on the basis of maintaining a prudent profile of debt maturity based on the following limits:

Maturity period	Upper	Lower
Under 12 months	20%	0%
12 months to 2 years	50%	0%
2 years to 5 years	75%	0%
5 years to 10 years	75%	0%
10 years and above	90%	0%

In terms of interest rate exposure on investments the Council through both in-house and externally managed funds will use a variety of instruments that could be classified as fixed or variable. In-house funds will invariably be restricted to fixed deposits and known interest rate bearing accounts. The level of exposure by the external cash fund manager will be limited by the restrictions contained within the current mandate.

Limit on Sums Invested Longer than 364 Days

The limit on the investment of sums **managed internally** for periods longer than 364 days is £5m for 2005/06 and the subsequent two financial years.

Under the current mandate the cash fund manager may invest within the following parameters:

- The maximum weighted average duration of the Funds holdings will be 3 years
- With the exception of the 10 year benchmark UK Government Gilt, the maximum maturity of any one holding must be 10 years or less