COUNCIL
28 FEBRUARY 2008

ITEM NO. 3 (b)

PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT STRATEGY REPORT 2008/09

Responsible Cabinet Member - Councillor Stephen Harker, Resources Portfolio

Responsible Director - Paul Wildsmith, Director of Corporate Services

---

Purpose of Report

1. This report requests the Council to consider the recommendations made by Cabinet relating to :-

   (a) Prudential indicators and limits relating to capital expenditure and Treasury Management activity.
   (b) A policy Statement relating to Minimum Revenue Provision.
   (c) The Treasury Management Strategy 2008/09, which includes the Investment Strategy for 2008/09.

Summary

2. "The Prudential Code for Capital Finance" ("the Code") was introduced in 2004, when local authorities were given extra freedoms to borrow without central government approval. The code uses Prudential Indicators and limits on borrowing activity to ensure that Councils' capital expenditure and financing decisions are prudent and affordable. Under the Code, the Council is required to approve three reports each year, one before the start of the year, one mid-year and one at the end of the year.

3. This report sets out the proposed capital expenditure, borrowing and investment activity for 2008/09 to 2010/11. The report contains Prudential Indicators that relate to capital expenditure and borrowing. Other statistics relating to treasury management are also included.

4. The information contained in the report regarding the Council's capital expenditure plans, Treasury Management and Prudential Borrowing activities indicates that they are: -

   (a) Within the statutory framework and consistent with the relevant codes of practice.
   (b) Prudent, affordable and sustainable.
   (c) An integral part of the Council's Revenue and Capital Medium Term Financial Plans.

5. A summary of the key prudential indicators and limits are contained in **Tables 1** and **2** below.

Table 1 – Capital Expenditure and Borrowing

	2007/08 Revised	**2008/09 Estimated**	**2009/10 Estimated**	**2010/11 Estimated**
	£m	£m	£m	£m
Capital Expenditure	49.452	38.415	29.893	30.062
Capital financing requirement	101.623	106.146	109.606	109.820
Operational boundary for external debt	103.623	108.146	111.606	111.820
Authorised limit for external debt	119.166	124.368	128.347	128.593
Ratio of financing costs to net revenue stream – General Fund	1.89%	1.79%	2.12%	2.24%
Ratio of financing costs to net revenue stream – HRA	10.68%	12.20%	14.22%	15.29%
Incremental impact of capital investment decisions on the band D Council Tax	Nil	Nil	Nil	Nil
Incremental impact of capital investment decisions on Housing Rents levels	Nil	Nil	Nil	Nil

Table 2 – Treasury Management

	2008/09 Upper Limit	2009/10 Upper Limit	2010/11 Upper Limit
Limits on fixed interest rates	100%	100%	100%
Limits on variable interest rates	40%	40%	40%
Maturity Structure of fixed interest rate borrowing			
	Upper Limit	**Upper Limit**	**Upper Limit**
Under 12 months	25%	25%	25%
12 months to 2 years	40%	40%	40%
2 years to 5 years	60%	60%	60%
5 years to 10 years	80%	80%	80%
10 years and above	100%	100%	100%
Maximum principal sums invested > 364 days	£15M	£15M	£15M

Information and Analysis

Introduction

6. This report covers the operation of the Council's prudential indicators, its Treasury Management function and its likely activities for the forthcoming year. The report incorporates four key Council reporting requirements: -

   (a) The reporting of prudential indicators in accordance with the requirements of the CIPFA Prudential Code for Capital Finance in Local Authorities with detailed analysis in **Appendix 1**.

   (b) A Policy Statement relating to provision in the revenue account for debt repayment

   (c) The Treasury Management Strategy for 2008/09 in accordance with the CIPFA Code of Practice on Treasury Management incorporating the summary of the Investment Strategy (in accordance with the Department of Communities and Local Government (CLG) investment guidance). It also includes specific treasury management prudential indicators.

   (d) The detailed investment criteria contained in **Appendix 3**.

7. This budgetary cycle provides for the fifth full year of the operation of the CIPFA Prudential Code. The Prudential Code operates by the provision of prudential indicators, which highlight aspects of the capital expenditure planning. Each indicator provided during

the 2007/08 budget process has been updated and provided for the next three years. These are detailed below. This is in accordance with the Prudential Code, which requires that Council approve certain mandatory indicators.

8. The purpose of the indicators is to provide a framework for capital expenditure decision-making. The prudential indicators highlight 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.

9. Capital expenditure decisions impact on the Council's treasury management activity, either through increased borrowing levels or the application of investment balances. Consequently the Treasury Management Strategy for 2008/09 is included in this report. This report also includes the Treasury Management Prudential Indicators. The production of the Treasury Management Strategy is a requirement of the CIPFA Code of Practice on Treasury Management.

10. In addition, part of the Treasury Management Strategy requirements is the formulation of an investment strategy. Investment guidance issued by the CLG during March 2004 overlaps into the Code of Practice requirements. The reporting requirements of the CLG guidance have therefore been incorporated into the Treasury Management Strategy.

CAPITAL EXPENDITURE, THE CAPITAL FINANCING REQUIREMENT AND ASSOCIATED PRUDENTIAL INDICATORS

Capital Expenditure

11. The Council's capital expenditure plans will be partially financed by resources such as capital receipts, capital contributions and capital grants. The remaining element, which cannot be immediately financed from other sources, will impact on the Council's underlying need to borrow, called the Capital Financing Requirement (CFR). The summary of capital expenditure financing and the impact on the CFR are show in **Tables 3 and 4** below. This forms one of the required prudential indicators. A more detailed analysis, breaking down the General Fund and the Housing Revenue Account split is shown in **Appendix 1.**

12. A certain level of borrowing will be supported by the Government through the Revenue Support Grant. Any borrowing above this level will be unsupported and will need to be financed from the Council's own resources.

13. The limiting factors on the Council's ability to undertake unsupported capital expenditure is the availability of

    (a) Revenue resources to support in full the implications of capital expenditure, both borrowing and ongoing running costs. i.e. Can the Council afford the implications of the unsupported borrowing?

    (b) The Government has reserve powers to implement specific limit on Council's capital expenditure plans. No such limits were implemented in the past four years and there is no indication of such controls for 2008/09.

14. A risk of the plan is that the level of government support has some estimates in for 2009/10 and 2010/11 and is therefore subject to change. Similarly some of the estimates for other sources of funding such as capital receipts may be subject to change over this timescale. The Council reviews and adjusts its capital expenditure plans annually, taking account of changes in projected future years' resources.

15. The Council is asked to approve the capital expenditure projections below. Service details are in **Appendix 1** and further details of Capital expenditure are contained in the Capital MTFP report. This forms the first prudential indicator.

Table 3

	2007/08 Revised	**2008/09 Estimate**	**2009/10 Estimate**	**2010/11 Estimate**
	£m	**£m**	**£m**	**£m**
Capital Expenditure				
Total Expenditure	**49.452**	**38.415**	**29.893**	**30.062**
Financed by				
Capital Receipts	7.778	5.196	0.700	0.700
Capital Grants	25.983	22.858	20.309	23.890
Capital Contributions	0.724	0.00	0.00	0.00
Revenue	2.274	1.871	1.547	1.146
Total Financing other than borrowing	36.759	29.925	22.556	25.736
Net financing need for the year	12.693	8.490	7.337	4.326

The Council's Borrowing Need (the Capital Financing Requirement)

16. The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is the total capital expenditure, which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. The capital expenditure above which has not been immediately been paid for will increase the CFR.

Minimum Revenue Provision Policy Statement

17. The Council is required to charge to its revenue account each year a provision to pay off an element of the accumulated General Fund capital debt (the Minimum Revenue Provision - MRP). The Council may also make additional voluntary payments (VRP) to further reduce the CFR. The proposal in the Corporate Plan and MTFP report to repay debt using capital receipts will constitute a VRP.

18. Draft CLG regulations are currently issued for comment, which, if implemented, will require the Council to approve an MRP Policy Statement. This will need to be approved in advance of each year. Whilst the regulations will revoke current MRP requirements, Councils are allowed to continue historical accounting practice for all capital borrowing incurred prior to 1st April 2008. However, in order to ensure that Local Authorities prudently repay debt incurred in later years, this method of calculation for MRP will only

relate to supported capital expenditure that is funded through Revenue Support Grant. Debt that is incurred for unsupported borrowing will have to be repaid over the life of the asset to which the capital expenditure relates. For both types of future capital expenditure there are 2 options.

19. For capital expenditure incurred before 1st April 2008 and future expenditure supported through the Revenue Support Grant the 2 options are:

    (a) Existing Practice- MRP will follow the existing practice outlined in the former CLG Regulations. This method is based on 4% of the opening balance sheet non-housing CFR but allows for an adjustment to the calculation based on figures prior to the implementation of the prudential code.

    (b) Based on CFR - MRP will be based on 4% of the opening balance sheet non-housing CFR, without adjustments.

20. From 1st April 2008 for all unsupported borrowing the MRP options are:

    (a) Asset Life Method – MRP will be based on the estimated life of the assets in accordance with the proposed regulations. This option must be applied for any expenditure capitalised under a Capitalisation Directive. These are items that would normally be classified as revenue but are allowed to be financed by capital resources.

    (b) Depreciation Method - MRP will follow standard depreciation accounting procedures usually on a straight line method or reducing balance.

21. It is proposed that Darlington Borough Councils MRP Policy will be

    (a) For capital expenditure incurred before 1st April 2008 and future expenditure supported through the Revenue Support Grant -

        Existing Practice as outlined in paragraph 19 (i) will be used.

    (b) From 1st April 2008 for all unsupported borrowing -

        The MRP will follow the Asset Life Method as outlined in Paragraph 20 (i).

22. This policy will give the Council the most flexibility when calculating MRP. Additional repayments of debt will always be available should the Council so wish in the form of Voluntary Revenue Payments.

23. Having regard to capital expenditure plans and MRP / VRP, the Council is asked to approve the CFR projections below: -

Table 4

	2007/08 Revised	2008/09 Estimate	2009/10 Estimate	2010/11 Estimate
	£m	£m	£m	£m
Capital Financing Requirement				
CFR – General Fund	70.239	71.291	72.262	72.532
CFR – Housing	31.384	34.855	37.344	37.288
Total CFR	**101.623**	**106.146**	**109.606**	**109.820**
Net movement in CFR	8.155	4.523	3.460	0.214
Movement in the CFR represented by				
Net financing need for the year from Table 3	12.693	8.490	7.337	4.326
MRP/VRP and other financing movements	-4.538	-3.967	-3.877	-4.112
Movement in CFR	8.155	4.523	3.460	0.214

24. The expected impact of the capital expenditure decisions on the Council's debt and investment position are shown below.

Limits to Borrowing Activity

25. Within the prudential indicators there are a number of key indicators to ensure the Council operates its activities within well-defined limits.

26. For the first of these the Council needs to ensure that its total borrowing net of any investments does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2007/08 and next two financial years. This allows some flexibility for limited early borrowing for future years.

Table 5

	2007/08 Revised	2008/09 Estimate	2009/10 Estimate	2010/11 Estimate
	£m	£m	£m	£m
Gross Borrowing	101.623	106.146	109.606	109.820
Investments	-47.740	-49.600	-42.200	-41.300
Net Borrowing	53.883	56.546	67.406	68.520
CFR (from Table 4)	101.623	106.146	109.606	109.820

27. The Council will comply with the prudential indicator requirement to keep net borrowing below the relevant CFR in the current year, and the above table confirms that no difficulties are envisaged for the current or future years. This view takes into account current commitments, existing plans and the proposals in the Revenue and Capital Medium Term Financial Plans.

28. A further two prudential indicators control the overall level of borrowing. These are:

(a) **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.

(b) **The Authorised Limit –** This represents the limit beyond which borrowing is prohibited, and this limit 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 expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

29. The Council is asked to approve the following operational and authorised limits.

Table 6

	2007/08 Revised	**2008/09 Estimate**	**2009/10 Estimate**	**2010/11 Estimate**
Operational Boundary	**£m**	**£m**	**£m**	**£m**
Borrowing as per Capital MTFP	101.623	106.146	109.606	109.820
Estimated additional supported borrowing	0.500	0.500	0.500	0.500
Prudential Borrowing to cover leasable assets	1.000	1.000	1.000	1.000
Possible Prudential Borrowing under Directors delegated powers	0.500	0.500	0.500	0.500
Operational Boundary	**103.623**	**108.146**	**111.606**	**111.820**
Additional Headroom as a % of Operational Boundary for External Debt	15%	15%	15%	15%
Authorised Limit	**119.166**	**124.368**	**128.347**	**128.593**

Affordability Prudential Indicators

30. 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:

31. **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 investment income) as a percentage of the net revenue budget, both for the General Fund and the Housing Revenue Account.

Table 7 - Ratio of financing costs to net revenue stream

	2007/08 Revised	2008/09 Estimate	2009/10 Estimate	2010/11 Estimate
General Fund	**1.89%**	**1.79%**	**2.12%**	**2.24%**
HRA	**10.68%**	**12.20%**	**14.22%**	**15.29%**

32. The estimates of financing costs include current commitments and the proposals in Revenue and Capital MTFP reports.

33. **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, and therefore relates to ***new schemes*** within this MTFP round. There are no new schemes within this Capital MTFP that are dependant on new unsupported corporate prudential borrowing which will increase Council Tax. However, there may be some departmental unsupported borrowing to be undertaken in the form of 'invest to save' schemes and replacing leased assets i.e. computer equipment with assets paid for by prudential borrowing, the repayment of this borrowing will be accommodated within Departmental resource allocations, which will therefore have no incremental effect on Council Tax.

Table 8 – Incremental impact of capital investment decisions on the Band D Council Tax

	Proposed Budget 2008/09 £	Forward Projection 2009/10 £	Forward Projection 2010/11 £
Incremental impact of **new** capital investment decisions on the Band D Council Tax.	**Nil**	**Nil**	**Nil**

34. **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 this budget report, compared to the Council's existing commitments and current plans, expressed as a change in weekly rent levels. In July 2004 Council approved a decision to prudentially borrow up to £20m over six years to invest in Council Housing in order to meet the Decent Homes Standard. However, the additional repayment costs of the debt incurred are to be accommodated within the Housing Revenue Account resources, the increased financing charges will be compensated by a reduction in other management costs, therefore, there is to be no incremental effect on housing rent levels.

Table 9 – Incremental impact of capital investment decisions Housing Rent levels

	Proposed Budget 2008/09 £	Forward Projection 2009/10 £	Forward Projection 2010/11 £
Weekly Housing Rents	**Nil**	**Nil**	**Nil**

TREASURY MANAGEMENT STRATEGY 2008/09 – 2010/11 INCLUDING THE TREASURY MANAGEMENT PRUDENTIAL INDICATORS AND LIMITS ON ACTIVITY.

35. 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. Whilst the prudential indicators above consider the affordability and impact of capital expenditure decisions, the treasury management service covers the effective funding of these decisions. There are also specific treasury management prudential indicators included in this strategy which need approval.

36. The Council's 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 21st March 2002 (Min. Ref. 63/Mar/2002 refers), and as a result adopted a Treasury Management Policy Statement. This adoption meets the requirements of the first of the Treasury Management prudential indicators and so the Council consistently and continually complies with this indicator.

37. The Treasury Management Policy requires an annual strategy to be reported to Cabinet/Council outlining the expected treasury activity for the forthcoming 3 years. Two further reports are produced one mid-year reporting on activity part way through the year and the other after the year-end to report on actual activity for the year.

38. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the Treasury Management service.

39. This strategy covers:-

    (a) The Council's debt and investment projections.
    (b) The expected movement in interest rates.
    (c) The Council's borrowing and investment strategies.
    (d) Treasury Management performance indicators.
    (e) Specific limits on Treasury Management activities.
    (f) Any local Treasury Management issues.

Debt and Investment Projections 2008/09 – 2010/11

40. The borrowing requirement comprises of the expected movement in the CFR and any maturing debt, which will need to be refinanced. The table below shows this effect on the treasury position over the next three years. It also highlights the expected change in investment balances.

Table 10

	2007/08 Revised £m	2008/09 Estimate £m	2009/10 Estimate £m	2010/11 Estimate £m
External Debt				
Debt at 1st April	95.242	101.623	106.146	109.606
Movement in CFR	8.155	4.523	3.460	0.214
Maturing Debt Replacement	0.00	0.00	0.00	0.00
Adjustment for prior years	-1.774	0.00	0.00	0.00
Debt at 31st March	101.623	106.146	109.606	109.820
Annual change in debt	6.381	4.523	3.460	0.214
Investments				
Total Investments at 31st March	47.740	49.600	42.200	41.300
Investment Change	4.274	1.860	-7.400	-0.900

Expected Movement in Interest Rates

41. There is always a risk to the Treasury Management Budget from an adverse move 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 Butlers, the treasury consultants, to advise on the Treasury Management Strategy, to provide economic data and interest rate forecasts, to assist planning and reduce the impact of unforeseen adverse movements. Butlers' view of the UK and world economy and the effects this will have on UK interest rates is attached at **Appendix 2**

Table 11 – Expected Movements in Interest Rates
Medium-Term Rate Forecasts* - (Averages – Source Butlers)

Average %	Base Rate	5-year Gilt*	20-year Gilt*	50-year Gilt*
2006/07	4.8	4.9	4.4	4.0
2007/08	5.6	5.3	4.9	4.5
2008/09	4.8	4.7	4.8	4.6
2009/10	4.8	4.8	4.7	4.6
2010/11	5.0	4.9	4.8	4.8
2011//12	5.2	5.3	5.2	5.1

*PWLB borrowing is normally between 0.10%- 0.15% above the equivalent gilt yield.

Borrowing and Debt Strategy 2008/09 – 2010/11

42. The uncertainty over future interest rates increases the risks associated with the Treasury Management Strategy. As a result the Council will continue to take a cautious approach to its Treasury Management Strategy.

43. Long-term fixed interest rates are expected to be higher over the medium term. The Director of Corporate Services, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above. It is likely that longer term fixed rates will be considered if borrowing rates remain relatively low. This may include borrowing in advance of future years requirements.

44. With the likelihood of increasing interest rates any debt restructuring is likely to take place later in the financial year or in future years, although the Director of Corporate Services will monitor prevailing rates for any opportunities during the year.

45. A key change in the options for borrowing and rescheduling occurred on 1st November 2007 when the Public Works Loan Board changed its interest rate structure to a more sensitive pricing method and also increased the relative cost of repaying debt. This will prompt a more cautionary approach to both borrowing and rescheduling debt.

46. During 2008/09 it is expected that the Council will need to borrow an additional £8.490m to cover part of its Capital Programme, see **Table 3,** and of this £4.670m will be supported by revenue grant through the Relative Needs Formula of the Revenue Grant Settlement. Although £3.820m will be unsupported for Housing Revenue Account this has already been approved by Council. However, after taking account the statutory MRP and VRP it is expected that borrowing will only rise by £4.523m.

Investment Counterparty and Liquidity Framework

47. The primary 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 is also a key consideration. After this main principle the Council will ensure:

    (a) It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may be prudently committed. These procedures also apply to the Councils prudential indicators covering maximum principal sums invested.

    (b) It maintains a policy covering both 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 in **Appendix 3** for approval.

48. The Director of Corporate Services will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit it to the Council for approval as necessary. This criteria is separate to that which chooses Specified and Non-Specified as it selects which counterparties the Council will choose rather than defining what its investments are.

    (a) Banks - The Council will use banks which have at least the following Fitch or equivalent ratings

        (i) Short Term – F1
        (ii) Long Term – A-
        (iii) Individual – C (Fitch/Moodys only)
        (iv) Support – 3 (Fitch only)

    (b) Building Societies – the Council will use all Building Societies with assets in excess of £1,000m.

(i) Money Market Funds.
(ii) UK Government including the Debt Management Office.
(iii) Local Authorities etc.

49. In the normal course of the Council's cashflow operations it is expected that both Specified and Non-specified will be utilised for the control of liquidity as both categories allow for short term investments.

50. The use of longer term instruments (greater than one year from inception to repayment) will fall in the Non-specified investment category. These instruments will only be used where the council's liquidity requirements are safeguarded. The investment prudential indicator in **Table 13** will also limit this.

Investment Strategy 2008/09 – 2010/11

51. Expectations on shorter-term interest rates, on which investment decisions are based, show that bank base rate has peaked at 5.75% and that further falls are expected during 2008/09. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts. It is likely that investment decisions will be made for longer periods with fixed investments rates to lock in good value and security of return if opportunities arise, subject to over riding credit counterparty security. The Director of Corporate Services, 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 in **Table 11** above.

Sensitivity to Interest Rate Movements

52. Future Council accounts will be required to disclose the impact of risks on the Council's Treasury Management activity. Whilst most of the risks facing the treasury management service are addressed elsewhere in this report (credit risk, liquidity risk, market risk, and maturity profile risk). The impact of interest rate risk is discussed but not quantified. The table below highlights the estimated impact of a 1% increase/ decrease in all interest rates to treasury management costs/income for next year.

Table 12

	2008/09 Estimated +1% £m	2008/09 Estimated -1% £m
Revenue Budgets		
New Debt Interest on Borrowing	0.045	-0.045
Related HRA Charge	0.035	-0.035
Net General Fund Borrowing Cost	0.010	-0.010
Investment Income	-0.397	+0.397

Treasury Management Prudential Indicators and Limits on Activity

53. There are four further Treasury Management Prudential Indicators. The purpose of these prudential indicators is to contain the activity of the Treasury Management function within

certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs. The indicators are:

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

(b) Upper limits on variable rate exposure – Similar to the previous indicator this covers a maximum limit on variable interest rates based upon the debt position net of investments.

(c) Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing in any one year, both upper and lower limits are required.

(d) Total principal funds invested for greater than 364 days – 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.

54. The Council is asked to approve the following prudential indicators:-

Table 13

<table>
<tr><td></td><td colspan="2">2008/09</td><td colspan="2">2009/10</td><td colspan="2">2010/11</td></tr>
<tr><td></td><td colspan="2">Upper</td><td colspan="2">Upper</td><td colspan="2">Upper</td></tr>
<tr><td>Limits on fixed interest rates</td><td colspan="2">100%</td><td colspan="2">100%</td><td colspan="2">100%</td></tr>
<tr><td>Limits on variable interest rates</td><td colspan="2">40%</td><td colspan="2">40%</td><td colspan="2">40%</td></tr>
<tr><td colspan="7">Maturity Structure of fixed interest rate borrowing</td></tr>
<tr><td></td><td>Lower</td><td>Upper</td><td>Lower</td><td>Upper</td><td>Lower</td><td>Upper</td></tr>
<tr><td>Under 12 months</td><td>0%</td><td>25%</td><td>0%</td><td>25%</td><td>0%</td><td>25%</td></tr>
<tr><td>12 months to 2 years</td><td>0%</td><td>40%</td><td>0%</td><td>40%</td><td>0%</td><td>40%</td></tr>
<tr><td>2 years to 5 years</td><td>0%</td><td>60%</td><td>0%</td><td>60%</td><td>0%</td><td>60%</td></tr>
<tr><td>5 years to 10 years</td><td>0%</td><td>80%</td><td>0%</td><td>80%</td><td>0%</td><td>80%</td></tr>
<tr><td>10 years and above</td><td>0%</td><td>100%</td><td>0%</td><td>100%</td><td>0%</td><td>100%</td></tr>
<tr><td>Maximum principal sums invested > 364 days</td><td colspan="2">£15M</td><td colspan="2">£15M</td><td colspan="2">£15M</td></tr>
</table>

55. **Table 14** below shows the maturity profile of debt outstanding at 31st March 2007.

Table 14

Analysis of Loans Maturity	**Actual at 31st March 2007**	
	£m	**%**
Under 12 months	Nil	0.0
12 months to 2 years	Nil	0.0
2 years to 5 years	Nil	0.0
5 years to 10 years	Nil	0.0
10 years and above	95.242	100
Total	95.242	100
Variable Debt	Nil	0.0

Performance Indicators

56. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the Treasury Management function over the year. These are distinct historic performance indicators, as opposed to the Prudential Indicators, which are predominantly forward looking. Below are the performance indicators currently used by Darlington Borough Council for its Treasury Management function :-

(a) **Debt** – Average overall interest rate paid compared with previous years.

(b) **Investments – Short term** - cashflow investment rate returned against comparative average rates.

(c) **Investments – Longer term** - capital investment rates returned against comparative average rates.

The results of these indicators will be reported in the Treasury Management Half Year Review and Annual Reports for 2008/09.

Outcome of Consultation

57. This report was presented to Cabinet at their meeting on 16th January 2008. Cabinet agreed the recommendations and forwarded the report to Resources Scrutiny for consideration. Resources Scrutiny examined the report at their meeting on 29th January 2008 and supported those recommendations. Cabinet further considered the report and the views of Resources Scrutiny Committee at the special meeting of Cabinet on 19th February 2008. At that meeting Cabinet agreed to recommend to Council the proposals contained in paragraph 61 of this report.

Legal Implications

58. This report has been considered by the Borough Solicitor for legal implications in accordance with the Council's approved procedures. There are no issues which the Borough Solicitor considers need to be brought to the specific attention of Members, other than those highlighted in the report.

Section 17 of the Crime and Disorder Act 1998

59. The contents of this report have been considered in the context of the requirements placed on the Council by Section 17 of the Crime and Disorder Act 1998, namely, the duty on the Council to exercise its functions with due regard to the likely effect of the exercise of those functions on, and the need to do all that it reasonably can to prevent, crime and disorder in its area. It is not considered that the contents of this report have any such effect.

Council Policy Framework

60. The issues contained within this report are required to be considered by Council.

Recommendation

61. Council are requested to :-

    (a) Adopt the prudential indicators and limits for 2007/08 to 2010/11 contained within this report in **Tables 3 to 10.**

    (b) Approve the Minimum Revenue Provision (MRP) Policy Statement contained in paragraph 21.

    (c) Approve the Treasury Management Strategy 2008/09 contained in paragraphs 35 to 57 and the treasury prudential indicators contained in **Table 13.**

    (d) Approve the Investment Strategy 2008/09 contained in the Treasury Management Strategy, and the detailed criteria included in **Appendix 3**. Specifically approving the criteria for specified investments and the criteria for non-specified investments.

Reasons

62. The recommendations are supported by the following reasons: -

    (a) In order to comply with the Prudential Code for Capital Finance in Local Authorities and ODPM guidance on investments.

    (b) To comply with the requirements of the Local Government Act 2003.

    (c) To approve a framework for Officers to work within when making investment decisions.

Paul Wildsmith
Director of Corporate Services

Background Papers

CIPFA The Prudential Code for
Capital Finance in Local Authorities
Annual Statement of Accounts 2006/07
Draft Capital MTFP 2008/09-2010/11

Elaine Hufford : Extension 244

	CAPITAL EXPENDITURE AND THE SOURCES OF FINANCE					
			2007/08 Revised £m	2008/09 Estimated £m	2009/10 Estimated £m	2010/11 Estimated £m
	Capital Expenditure – General Fund					
1	Supported spend		31.744	26.891	19.773	22.922
2	Unsupported spend		4.044	0.000	0.160	0.000
3	Total spend	*Lines 1+2*	35.788	26.891	19.933	22.922
	Financed by:					
4	Capital receipts		6.428	3.996	0.000	0.000
5	Capital grants		20.841	18.315	15.725	19.306
6	Capital Contribution		0.724	0.000	0.000	0.000
7	Revenue		0.086	0.000	0.000	0.000
8	Total financing	***Lines*** *4 to 7*	28.079	22.311	15.725	19.306
9	Net financing need	*3 - 8*	7.709	4.670	4.208	3.616
	Capital Expenditure – Housing Revenue Account					
10	Supported spend		8.680	7.614	6.831	6.430
11	Unsupported spend		4.984	3.820	3.129	0.710
12	Total spend	*10+11*	13.664	11.434	9.960	7.140
	Financed by:					
13	Capital receipts		1.350	1.200	0.700	0.700
14	Capital grants		5.142	4.543	4.584	4.584
15	Capital Contribution		0.000	0.000	0.000	0.000
16	Revenue		2.188	1.871	1.547	1.146
17	Total financing	*13 to 16*	8.680	7.614	6.831	6.430
18	Net financing need	*12 - 17*	4.984	3.820	3.129	0.710
	Capital Expenditure – Total					
19	Supported spend	*1+10*	40.424	34.595	26.604	29.352
20	Unsupported spend	*2+11*	9.028	3.820	3.289	0.710
21	Total spend	*19+20*	49.452	38.415	29.893	30.062
	Financed by:					
22	Capital receipts	*4+13*	7.778	5.196	0.700	0.700
23	Capital grants	*5+14*	25.983	22.858	20.309	23.890
24	Capital Contributions	*6+15*	0.724	0.000	0.000	0.000
25	Revenue	*7+16*	2.274	1.871	1.547	1.146
26	Total financing	*22 to 25*	36.759	29.925	22.556	25.736

27	**Net financing need**	*21 - 26*	**12.693**	**8.490**	**7.337**	**4.326**
	THE CAPITAL FINANCING REQUIREMENT					
			2007/08 Revised £m	**2008/09 Estimated £m**	**2009/10 Estimated £m**	**2010/11 Estimated £m**
	The Capital Financing Requirement - General Fund					
28	CFR Opening Balance		67.069	70.240	71.292	72.263
29	Net financing need	*9*	7.709	4.670	4.208	3.616
30	Less MRP & VRP		-4.538	-3.618	-3.237	-3.346
31	CFR Closing balance	*28 to 30*	70.240	71.292	72.263	72.533
32	Net movement in CFR	*31-28*	3.171	1.052	0.971	0.270
	The Capital Financing Requirement - HRA					
33	CFR Opening Balance		26.400	31.384	34.855	37.343
34	Net financing need	*18*	4.984	3.820	3.129	0.710
35	Less V RP		0.000	-0.349	-0.641	-0.766
36	CFR Closing balance	*33 to 35*	31.384	34.855	37.343	37.287
37	Net movement in CFR	*36-33*	4.984	3.471	2.488	-0.056
	The Capital Financing Requirement - Total					
38	CFR Opening Balance	*28+33*	93.469	101.624	106.147	109.606
39	Net financing need	*29+34*	12.693	8.490	7.337	4.326
40	MRP & VRP	*30+35*	-4.538	-3.967	-3.878	-4.112
41	CFR Closing balance	*38 to 40*	101.624	106.147	109.606	109.820
42	**Net movement in CFR**	*41-38*	**8.155**	**4.523**	**3.459**	**0.214**

MRP - Minimum Revenue Provision
VRP - Voluntary Revenue Provision

BUTLERS VIEW OF UK AND WORLD ECONOMY AND ITS EFFECT ON UK INTEREST RATES

1. ***Short Term Interest Rates*** *- While the December cut in Bank Rate ultimately came as no great surprise to the financial markets it did reflect the Monetary Policy Committee's growing unease about the state of the domestic economy.*

2. *The November Inflation Report did highlight the threat of a comparatively steep decline in economic activity in 2008. However, until then there had been few decisive signals that this process had commenced in earnest. More recently, the economic data has been transmitting an increasing amount of evidence that this may indeed be the case.*

3. *The cooling in the housing market has been noted for some time although it is only in the past few months that the two key indicators on this front (the Nationwide & Halifax Indices) have moved down in unison. The deciding factors behind the MPC's decision were probably the November CIPS surveys of the manufacturing and service sectors.*

4. *Both these indicators pointed towards a marked deceleration in activity on a broad front and may well have been interpreted by the policy doves as a sure sign that the effects of the summer's credit squeeze are beginning to spread beyond the confines of the financial markets.*

5. *The squeeze on credit represents a sharp and involuntary tightening of domestic monetary policy. The fact that it is likely to take some time to evaporate suggests that consumers' expenditure (which has still to see the full effects of the adjustment of discounted, fixed-rate mortgages) will eventually respond through a marked contraction.*

6. *This, along with an easing of capacity constraints as the economy slows down, is expected to reduce inflation pressures and ensure CPI growth reverts to the 2% central target rate over the medium term.*

7. *Nevertheless, the Bank of England does note that the upside risks to inflation remain. Many of the current pressures are externally generated (oil, food, commodity prices etc) and will not respond to UK interest rate policy.*

8. *Hopes rest upon the anticipated deceleration in international activity reversing at least some of these trends. In the mean time, the MPC is hoping that domestic inflation expectations do not deteriorate and that weakening household consumption prevents companies passing cost increases on to the retail level. The outcome of this "central case" scenario will not be known for some time.*

9. ***Longer Term Interest Rates*** *- Bond markets (which underpin the Council borrowing rates) will remain aware of the risks policy makers are taking with inflation for the sake of engineering a gradual and moderate dip in economic activity. Concerns about the health of the financial sector will persist for some time and these will maintain the downward bias to bond yields in the near term.*

10. *However, investors may be unsettled by the risks central banks are taking with long-term inflation control in their attempts to shore up faltering activity. Worries about inflation prospects in the medium to long term are expected drive yields higher through 2008/09 and beyond.*

TREASURY MANAGEMENT PRACTICE (TMP)1 (5)- CREDIT AND COUNTERPARTY RISK MANAGEMENT

1. The Office of the Deputy Prime Minister (now CLG) issued investment guidance on 12th March 2004, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds, which are regulated by a different regulatory regime.

2. 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 CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council adopted the Code on 21st March 2002 (Min. Ref. 63/Mar/2002 refers) and will apply its principles to all investment activity. In accordance with the Code, the Director of Corporate Services has produced its Treasury Management Practices (TMP's) and this part TMP 1 (5), covering investment counterparty policy requires approval each year.

Annual Investment Strategy

3. The key requirements of both the Code and the investment guidance are to set an annual investment strategy as part its annual Treasury Management strategy for the following year, covering the identification and approval of the following:

   (a) The strategy guidelines for decision making on investments, particularly non-specified investments.
   (b) The principles used to determine the maximum periods for which funds can be committed.
   (c) Specified investments the Council will use. These are high security (i.e. high credit rating, although this defined by the Council, and no guidelines are given), and high liquidity of investments in sterling with a maturity of no more than a year. This will need to define broad categories of investment and regularity of monitoring.
   (d) 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.

4. Specified and non-specified investments are both approved under the new guidance and both should normally form part of the Council's policy.

5. Throughout this Strategy the investments that will be used are Sterling fixed term or Variable deposits of up to 5 years with Banks and Building Societies, UK Government and other local authorities.

6. This Strategy is to be approved by Council.

Strategy Guidelines

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

   a) **It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may be prudently committed. These procedures also apply to the Councils prudential indicators covering maximum principal sums invested.**
   b) **It maintains a policy covering both 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.**

8. The Director of Corporate Services will maintain counterparty list in compliance with these criteria and will revise the criteria and submit it to Council for approval as necessary. The current proposed criteria are shown below

Liquidity of Investments

9. The Council will carefully balance the use of specified investments and non-specified investments into the future to ensure there is appropriate operational liquidity. In the normal course of the Council's cash flow operations it is expected that both specified and non-specified investments will be utilised for the control of liquidity as both categories allow for short term investments.

10. The use of longer term instruments (greater than one year from inception to repayment) will fall in the non-specified category. These instruments will only be used where the Council's liquidity requirements are safeguarded. An estimate of term investments is included in the main body of this report. The following estimates for longterm investments were included for the next three years 2008/09 £15m, 2009/10 £15m and 2010/11 £15m

Specified Investments

11. These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the council has the right to be repaid within 12 months if it wishes. These are low risk assets where the possibility of loss of principal or investment income is negligible. These would include investments with:-

    a) The UK Government (such as the Debt Management Office, UK Treasury Bills or gilts).

    b) Supranational bonds.

    c) A local authority, parish council or community council.

    d) An investment scheme that has been awarded a high credit rating by a credit rating agency. This covers money market funds rated AAA by Standard and Poors, Moody's or

Fitch rating agencies

e) A body that has been awarded a high credit rating by a credit rating agency (such as a bank or building society) This covers bodies with a minimum rating of :-

i) Short Term Rating- F1 (or equivalent) from Fitch, Moody's or Standard & Poors

ii) Long Term Rating- A or equivalent from Fitch, Moody's or Standard & Poors

iii) Individual / Financial Strength Rating – C from Fitch or Moody's Support Rating – 3 from Fitch

12. Within these bodies and in accordance with the code, the Council has set additional criteria to set the time limit and amount of monies which will be invested.

Non-Specified Investments

13. Non-specified investments are any type of other investment not defined as Specified and will include any investments for more than one year. These would include :-

	Non Specified Category	Total Limit for category £m
a.	Building Societies not meeting the basic security requirements under the specified investments. The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings.	£14.000
b.	Any Bank or Building Society that has a minimum long term credit rating of A or equivalent for Fitch or Moody's, for deposits with a maturity of greater than one year. This would include forward deals in excess of one year from inception to repayment.	£15.000
	Total Investments in Non Specified Category	£29.000

14. The table 1 below shows the minimum credit rating (or asset size, relating to Building Society's) required for inclusion on the Council counterparty list.

Table 1

	Fitch				Moody's			Asset Size
Type	**Short Term**	**Long Term**	**Ind.**	**Support**	**Short Term**	**Long Term**	**Financial Strength**	
Bank	F1	A-	C	3				-
MMF	AAA				AAA			-
DMADF	-				-			-
Building Society (1)					P-1	A3	C	-
Building Society (2)	-	-	-	-	-	-	-	>£1bn

15. Table 2 shows investment time and money limits categorised between specified and non specified investments

Table 2

	Fitch				Moody's			Asset Size		
Type	**Short Term**	**Long Term**	**Ind**	**Support**	**Short Term**	**Long Term**	**Financial Strength**		**Time Limit**	**Money limit**
Specified										
Bank / Building Society	F1	-	-	-	P-1				1 year	£5m
Building Society					P-2				9 months	£2m
MMF	AAA							-	1 year	£5m
DMADF	-				-			-	1 year	£5m
Non-Specified										
Un-rated BS	-	-	-	-	-	-	-	>£1bn	6 months	£2m
Long term Bank / BS	F1	A-	C	3	P-1	A3	C		2 years	£3m
	F1	AA-	B	2	P-1	Aa3	B		4 years	£5m
	F1	AAA	B	1	P-1	Aaa	B		5 years	£5m

The Monitoring of Investment Counterparties

The credit rating of counterparties is monitored regularly. The Council receives credit rating advice from its advisers, Butlers, on a daily basis as and when ratings change, and counterparties are checked promptly. On occasions ratings may be downgraded when an investment has already been made. 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 Corporate Services, and if required new counterparties which meet the criteria will be added to the list.