Report to: **Council**

Subject: **Treasury Management Strategy Statement and Annual Investment Strategy 2005/2006**

Date: **16 March 2005**

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PURPOSE OF REPORT

To seek Members' approval to the Council's Treasury Management Strategy Statement and Annual Investment Strategy for 2005/06.

BACKGROUND

The Local Government Act 2003 requires the Council to have regard to the Prudential Code and to set indicators for the next three years, to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

The Act therefore requires the Council to set out its Treasury Strategy for borrowing, and to prepare an Annual Investment Strategy setting out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

The ODPM's investment guidance was issued too late for the Annual Investment Strategy (AIS) to be included in the Treasury Management Strategy Statement (TMSS) for 2004/05. However, the guidance stated that in future years, authorities could combine the TMSS and the AIS into one report. The Council has adopted that suggestion, and the AIS is therefore included at paragraph 7.

The suggested strategy for 2005/06 in respect of the following aspects of the treasury management function is based upon the Head of Finance's views on interest rates, supplemented with market forecasts provided by the Council's treasury advisor. The strategy covers:

1) Treasury limits in force which will limit the treasury risk and activities of the Council
2) Prudential Indicators
3) The current treasury position

4) The borrowing requirement
5) Prospects for interest rates
6) The Borrowing strategy
7) The Investment Strategy

PROPOSAL

(1) Treasury Limits for 2005/06 to 2007/08

It is a statutory duty under section 3 of the Local Government Act 2003 and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the “affordable borrowing limit”.

The Council must have regard to the Prudential Code when setting their affordable borrowing limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax and rent levels is acceptable.

Whilst termed an affordable borrowing limit, the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The affordable borrowing limit is to be set, on a rolling basis, for the forthcoming financial year and the two successive financial years.

(2) Prudential Indicators for 2005/06 to 2007/08

The Prudential Code requires the Council to indicate whether it has adopted the Cipfa Code of Practice on Treasury Management. It is hereby confirmed that this Authority has adopted this Code.

Appendix 1 details the prudential indicators required for the purpose of setting an integrated Treasury Management Strategy. The Prudential Indicators were approved by Council on 9 February 2005. Section 1 details those indicators that are based on estimates of expected outcomes, and includes four key indicators of affordability:

i. Ratio of Financing Costs to Net Revenue Stream
ii. Incremental Impact of Capital Investment Decisions
iii. Capital Expenditure
iv. Capital Financing Requirement

Section 2 details those indicators that are based on limits, beyond which activities should not pass without management action. These include two indicators of affordability and five indicators of prudence:

<u>Affordability</u>

i. Authorised Limit for External Debt
ii. Operational Boundary for External Debt

Prudence

i. Net Borrowing and the Capital Financing Requirement
ii. Upper limit for fixed interest rate exposure
iii. Upper limit for variable rate interest exposure
iv. Upper limits for the maturity structure of borrowing
v. Upper limit for principal sums invested for periods over 364 days

(3) Current Portfolio Position

The Council's treasury portfolio position at 31 December 2004 is detailed below:

	£	Av Rate %
Total Debt	**0**	n/a
Total Investments	**10,000,000**	4.75
Net Borrowing / (Investment)	**(10,000,000)**	

(4) Borrowing Requirement

The Council's estimated borrowing requirement for the years 2004/05, and its anticipated requirements for the years 2005/06 to 2007/08 are detailed below:

	2004/05 £m	2005/06 £m	2006/07 £m	2007/08 £m
New Borrowing	0	2.5	2.5	2.5
Alternative Financing Arrangements	0	0	0	0
Total	**0**	**2.5**	**2.5**	**2.5**

(5) Prospects for Interest Rates

The Council has appointed Sector Treasury Services as its treasury advisors, and part of their service is to assist the Council to formulate a view on interest rates. Appendix 2 draws together the Sector central view and those of a number of city forecasters for short term or variable (base rate or repo rate) and longer term fixed interest rates.

The next section gives Sectors's current view on a number of factors.

UK Economic Background:

- *Above trend GDP robust, but indications of weakening activity ahead*
- *Slowdown in household spending and weakening housing market*
- *Benign inflation at present, may rise in 2005 as high street competition cannot sustain the current situation against the effect of rising oil prices*

- *Sterling expected to remain at $1.80 or above*

International Economic Background:

- *Measured interest rate raising by the Federal Reserve in US, weak trend employment data*
- *Consumer slowdown shows no sign of abating and this will be compounded by high oil prices, rising interest rates, the fading effects of past tax cuts and a faltering labour market*
- *Benign US inflation*
- *ECB has held repo rate at 2% since June 2003*
- *Weak domestic demand/export led growth indicates an economy about to suffer as world economy expected to slow*

Interest Rate Forecast:

The Base Rate is expected to rise to 5% in Q1 2005, but is nearing the peak of the cycle, and is consequently expected to fall back in 2005

Long Term 25 year PWLB rate:

- *Expected to remain around 4.75%*
  -Housing market to weaken from fast market increases causing consumers to feel the pinch
  -Slower global growth driven by weakness in the US

(6) Borrowing Strategy

Sector's view on the borrowing strategy is as follows:

The anticipation is that there is not likely to be much difference between short-term and long-term variable PWLB rates and medium and long-term PWLB fixed rate borrowing during 2005/06, provided that base rate falls from 5% to 4.75% as expected in quarter 3 of 2005. Variable rate borrowing will therefore be slightly more expensive than long-term fixed borrowing during quarter 2, but is expected to become cheaper in quarter 1 of 2006 when base rate is expected to fall to 4.5%. Thereafter, variable rate borrowing is expected to become still cheaper during 2006 and so the gap will widen further between long-term fixed and variable rates.

Long-term rates are not currently expected to move significantly in 2005/06, but may drift to the downside. These interest rates provide a variety of options:

- *That short-term variable rates will be good value compared to long-term rates, and are likely to remain so for potentially at least the next couple of years. Best value will therefore be achieved by borrowing short-term at variable rates in order to minimise borrowing costs in the short term or to make short-term savings in order to meet budgetary constraints. If fixed PWLB rates should fall significantly, then a suitable trigger point for considering new fixed rate long-term borrowing would be about 4.5%.*

- *That the risks intrinsic in the shorter term variable rates are such, when compared to historically relatively low long-term fixed funding, which may be achievable in 2005/06, that the Council will maintain a stable, longer term portfolio by drawing longer fixed rate funding at a marginally higher rate than short term rates.*

Against this background, caution will be adopted with the 2005/06 treasury operations. The Head of Finance will monitor the interest rate market and will adopt a pragmatic approach to changing circumstances, reporting any decisions to Cabinet at the next available opportunity.

Sensitivity of the Forecast – the main sensitivities of the forecast are likely to be the two scenarios below. Officers, in conjunction with the treasury advisers, will continually monitor both the prevailing interest rates and the market forecasts, adopting the following responses to the change of sentiment:

- If it was felt that there was a significant risk of a sharp rise in long term and short term rates, perhaps arising from a greater than expected increase in world economic activity, then the portfolio position will be reappraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap

- If it was felt that there was a significant risk of a sharp fall in long term and short term rates, eg. due to growth rates remaining low or weakening, then the long term borrowings will be postponed, and any rescheduling from fixed rate funding into variable or short rate funding will be exercised

(7) Annual Investment Strategy

(a) Investment Policy

<u>Investment Principals</u>

The Council will have regard to the ODPM's guidance on Local Government Investments ("the guidance") issued in March 2004 and Cipfa's Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the Cipfa TM Code").

All investments will be made in sterling, and the Council's general policy objective is the prudent investment of its treasury balances.

The Council's investment priorities are:

- The liquidity of its investments

  Based on its cashflow forecasts, the Council anticipates its fund balances in 2005/06 to range between £0m and £7m. Giving due consideration to the Council's level of balance over the next five years, the need for liquidity, its spending commitments and provisioning for contingencies, the Council has determined that £3m may be held in non-specified investments during the year. Appendix 3 sets out the maximum periods for which funds may be prudently committed in each asset category.

- The security of capital

  The credit quality of counterparties and investment schemes will be determined by reference to credit ratings published by Fitch. The Council has also established the minimum long and short-term and other credit ratings that it considers "high" for each category of investment. All ratings will be monitored monthly, and the Council is alerted to changes in Fitch ratings through its use of the Sector website. If a downgrade results in the counterparty or investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately. If a counterparty or investment scheme is upgraded so that it fulfils the Council's criteria, the Head of Finance will have the discretion to include it on the lending list.

The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The borrowing of monies purely to invest or on-lend and make a return remains unlawful, and the Council will not engage in such activity.

Specified and Non-Specified Investments

Investment instruments identified for use in the financial year are listed at Appendix 3 under "Specified" and "Non-Specified" categories. "Specified" investments will generally be used for cash flow management, and non-specified" for the longer- term investment of core balances. Counterparty limits will be as set out in the Council's Treasury Management Practices (Schedules). Appendix 3 also sets out:

- The advantages and associated risk of investments under the non-specified category
- The upper limit to be invested in each non-specified category
- Which instruments would best be used after consultation with the Council's treasury advisors

Investments defined as capital expenditure

The acquisition of share capital or loan capital in a body corporate is defined as capital expenditure under regulation 25(1)(d) of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003. Such investments will have to be funded out of capital or revenue resources, and will be classified as non-specified investments. Investments in "money market funds", which are collective investment schemes, and bonds issued by "multilateral development banks", both defined in SI 2004 No 534, will not be treated as capital expenditure. A loan or grant or financial assistance by this Council to another body for capital expenditure by that body will be treated as capital expenditure.

Provisions for credit-related losses

If any of the Council's investments appear to be at risk of loss due to default, ie this is a credit-related loss and not one resulting from a fall in price due to movements in interest rates, the Council will make revenue provision of an appropriate amount.

(b) Investment Strategy

In-house strategy

The Council's in-house managed funds are mainly cashflow derived, however, there is a core balance available, which may be invested over a 2-3 year period. Investments will accordingly be made with reference to the core balance and cashflow requirements, and the outlook for short-term interest rates (ie. for investments up to 12 months).

Sector is forecasting base rate to be on a falling trend from 5% in Q1 and Q2 of 2005 to 4.5% in Q1 and Q2 of 2006. The Council may therefore seek to lock into longer period investments at higher rates before this fall starts, for some of the element of its investment portfolio representing its core balance.

The Council will seek to use its business reserve accounts and short-dated deposits (1-3 months) in order to benefit from the compounding of interest at potentially higher rates.

The Council has identified 5% as an attractive "trigger" rate for 1 year lending, and 5.5% for 2-3 year lending. The trigger rates will be kept under review, and discussed with Sector so that investments can be made at the appropriate time.

End of Year Investment Report

At the end of the year, the Council will report on its investment activity as part of its Annual Treasury Report.

RECOMMENDATIONS

Members are asked to:

Approve the Treasury Management Strategy Statement and Annual Investment Strategy for 2005/06.