Report to: **Council**

Subject: **Treasury Management Strategy Statement and Annual Investment Strategy 2007/2008**

Date: **1 March 2007**

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PURPOSE OF REPORT

To seek Members' approval to the Council's Treasury Management Strategy Statement and Annual Investment Strategy for 2007/08.

BACKGROUND

Introduction

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 Management Strategy Statement (TMSS) for borrowing, and to prepare an Annual Investment Strategy (AIS) as required by Investment Guidance issued subsequent to the Act, 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 published in 2004 stated that authorities may combine the TMSS and the AIS into one report if they so wish, and the Council has adopted this approach.

The suggested strategy for 2007/08 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 leading 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) Debt rescheduling
8) The investment strategy
9) Large Scale Voluntary Transfer (LSVT)

It is a statutory requirement under section 33 of the Local Government Finance Act 1992 for the council to produce a balanced budget. In particular, section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore, means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from:

i. Increases in interest charges caused by increased borrowing to finance additional capital expenditure, and
ii. Any increases in running costs from new capital projects

are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

PROPOSAL

(1) Treasury Limits for 2007/08 to 2009/10

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 the Authorised Limit, which represents the affordable borrowing limit, and 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 Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and the two successive financial years.

(2) Prudential Indicators for 2007/08 to 2009/10

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 the Code.

Appendix 1 details the Prudential Indicators required for the purpose of setting an integrated Treasury Management Strategy. The indicators were approved by Council on 21 February 2007. 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 (CFR)

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:

Affordability

i. Authorised Limit for external debt (the “affordable borrowing limit”)
ii. Operational Boundary for external debt

Prudence

i. Net borrowing and the capital financing requirement (CFR)
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 January 2007 is detailed below:

	£	Av Rate %
Fixed Rate Borrowing - PWLB	**10,000,000**	4.07
Total Investments	**17,700,000**	5.30
Net Borrowing / (Investment)	**(7,700,000)**	

(4) Borrowing Requirement

The Council’s estimated borrowing requirement to finance its capital programme for the current year, 2006/07, and its anticipated requirements for the years 2007/08 to 2009/10 are detailed below. It should be noted that, due to favourable interest rates, borrowing in advance of actual cash flow need, but within the capital financing requirement Prudential indicator, has been undertaken during 2006/07, therefore the borrowing “requirement” differs to the actual borrowing undertaken.

	2006/07 £m	2007/08 £m	2008/09 £m	2009/10 £m
New Borrowing	3.5	4.9	0.0	2.2
Alternative Financing Arrangements	0.0	0.0	0.0	0.0
Total	**3.5**	**4.9**	**0.0**	**2.2**

(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 leading city forecasters for short term or variable (Bank Rate) and longer term fixed interest rates.

Interest Rate Forecast:

Sector's current view on interest rates is that Bank Rate will peak at 5.50% in Q1 of 2007, falling to 5.25% in Q3 and then to 5% in Q4 of 2007. Sector then expect further falls, to 4.75% in Q3 of 2008 and then to 4.50% in Q1 of 2009, before rates rise back to 4.75% in Q1 of 2010.

UK Economic Background:

- *The UK is on the upswing of the economic cycle from a low point reached in June 2005. Robust growth is expected to continue for a little longer, but a modest cooling is expected in 2007 (2006 2.7%, 2007 2.2%) and to continue at below the trend rate of 2.5% thereafter.*
- *Recovery in consumer spending and retail sales has underpinned this upswing in GDP.*
- *The housing market has proved more robust than expected with house price inflation over 8% per annum*
- *Higher than expected immigration from Eastern Europe has strengthened growth and dampened wage inflation*
- *The MPC's decisions to raise Bank Rate in November 2006 and January 2007 were needed to bring CPI inflation down to the 2% target level two years ahead. The MPC has been concerned that short term price increases (CPI has been significantly above target since June 2006) could feed through into wage settlements in the current pay round, and anchor inflation expectations at a higher level.*
- *Household income growth is expected to recover in 2007 as inflation falls and pay rises, however extra income is likely to go into a recovery of the savings rate, pension saving and servicing debt costs (as rates rise) rather than consumer expenditure*
- *Public sector real increase in expenditure per annum is expected to weaken to 2.5% over the next few years, from an average of 3% over the 2000 to 2005*
- *The three increases in Bank Rate in August and November 2006 and then January 2007 are expected to dampen the housing market and increases in unsecured borrowing, although one more increase in Bank Rate is forecast*

- *A world slowdown in growth in 2007 will dampen UK exports*

- *The outlook is that once inflation is back under control, Bank Rate will switch to a falling trend in the second half of 2007 to counter the above negative effects on the economy and growth*

International Economic Background:

- *The US, UK and EU economies have all been on the upswing of the economic cycle during 2005 and 2006, and so have been raising interest rates in order to cool their economies and to counter inflationary pressures stimulated by high oil, gas and electricity prices, which could feed through into increases in wage inflation, producer prices etc.*

- *The US is ahead of the UK and EU in the business cycle, and it looks as though the Federal Reserve Rate has already peaked at 5.25%, whereas there is still an expectation in the financial markets of further increases in the UK and EU.*

- *The major feature of the US economy is a still steepening downturn in the housing market which is likely to drag consumer spending, and so the wider economy, down with it (eg. house building, employment etc). Falling house prices will also undermine household wealth and so lead to an increase in savings (which fell while house prices were rising healthily) and so conversely will lead to a fall in consumer expenditure.*

- *The Federal Reserve may be reluctant and tardy to respond to the aforementioned downturn in the economy if inflationary pressures remain stubbornly high. This could exacerbate the downturn both in the US and the world economies.*

- *EU growth picked up strongly in the first half of 2006 and remained healthy in the second half. Growth is expected to slow moderately in 2007 due to weaker US and global demand.*

- *Despite sharply increased energy prices, disinflationary pressures from falls in prices of manufactured goods from China and India have helped to keep headline inflation in the advanced economies to an average of round 3% and will fall as the energy effects go into reverse.*

(6) Borrowing Strategy

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

- *The 50 year PWLB rate is expected to remain flat at 4.25%. As the Sector forecast is in 25bp segments, there is obviously scope for the rate to move around the central forecast by +/-25bp without affecting the overall forecast.*

- *The 25-30 year PWLB rate is expected to stay at 4.50% for the foreseeable future.*

- *The 10 year PWLB rate will fall from 5% to 4.75% in Q3 of 2007 and then fall again to 4.50% in Q1 of 2008 and remain at that rate for the foreseeable future.*

- *5 year PWLB rate will fall from 5.50% to 5.25% in Q2 of 2007, and continue falling until reaching 4.50% in Q1 of 2008, when it will remain at that rate for the foreseeable future.*

This forecast indicates, therefore, that the borrowing strategy for 2007/08 should be set to take very long dated borrowings at any time in the financial year. Variable rate borrowing and borrowing in the five year area are expected to be more expensive than long term borrowing and will therefore be unattractive throughout the financial year compared to taking long term borrowing.

For authorities wishing to minimise their debt interest costs, the main strategy is therefore as follows:

- *When the 50 year PWLB rate falls back to the central forecast of 4.25%, borrowing should be made in this area of the market at any time in the financial year. This rate will be lower than the forecast rates for shorter maturities in the 5 year and 10 year area. A suitable trigger point for considering new fixed rate long term borrowing, therefore, would be 4.25%.*

Against this background, caution will be adopted with the 2007/08 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 a 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, or further increases in inflation, 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 weakening, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term funding will be considered.

(7) Debt Rescheduling

As the first fall in Bank Rate is expected in Q3 of 2007, there will be a sharp difference between higher short term rates and cheaper long term rates in Quarters 2 to 3 of 2007. Later on in 2007/08, this advantage will diminish once Bank Rate, and short term rates generally, start falling. There will therefore be the opportunity during Quarters 2 to 3 of 2007 to restructure shorter term debt into long term in order to

optimise the potential savings achievable in the financial year 2007/08. Any positions taken via rescheduling will be in accordance with the strategy position outlined in paragraph 6 above.

In addition, the Council will actively give consideration during the year to taking advantage of small movements in PWLB rates to reduce the cost of existing debt in the portfolio by re-borrowing at lower rates without making significant changes to the type of debt (fixed or variable) or maturity periods.

The reasons for any rescheduling to take place will include:

- The generation of cash savings at minimum risk
- In order to help fulfil the strategy outlined in paragraph 6 above
- In order to enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility)

Cipfa issued a daft accounting standards document (SORP 2007) on 18 October 2006, and a final draft in November, which includes major potential changes in the treatment of the valuation of debt and investments, in the calculation of interest and the treatment of premia and discounts arising from debt rescheduling. There will be a three month consultation period before proposals are finalised. It is also expected that these proposals, once finalised, may make necessary the issue of legislation by the Government to take effect 1 April 2007. (DCLG issued draft regulations in November/December 2006). The authority's treasury management strategy will be reviewed once the final decisions in this area are known, to see whether any changes will be required in borrowing, investment or debt rescheduling strategies.

All rescheduling will be reported to Cabinet at the meeting following its action.

(8) Annual Investment Strategy

(8.1) 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 2007/08 to range between £0m and £10m. Giving due consideration to the Council's level of balances over the next five years, the need for liquidity, its spending commitments and provisioning for contingencies, the Council has

determined that a maximum of £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.

(8.2) 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 if appropriate. 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). As at 31 January 2007 the Council does not hold any investments spanning the financial year 2007/08, ie. maturing beyond 31 March 2008.

Interest Rate Outlook

Sector is forecasting Base Rate to peak at 5.50% in Q1 of 2007 before falling back to 5.25% in Q3 of 2007, to 5% in Q4 of 2007, to 4.75% in Q3 2008 and then to trough at 4.50% in Q1 of 2009, remaining at that level before rising again to 4.75% in Q1 of 2010. The Council should 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.

For its cashflow generated balances, 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.

For 2007/08, Sector recommends that the Council should budget for an investment return of 5%. Given the Council's current portfolio together with assumptions for the forthcoming year, the overall estimated equated rate assumed in the revenue budgets for 2007/08 is 5.08%.

The Council has identified 5.6% as an attractive "trigger" rate for both 1 year and 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.

(9) Large Scale Voluntary Transfer (LSVT

The proposed future LSVT raises a number of complex and critical decisions, which will need to be considered and planned for in advance of the physical cash transaction taking place. There may be an actual capital receipt, or an overhanging debt payment from DCLG. In each case the positioning and structure of borrowing will need to be considered from the outset, along with a strategy which takes account

of the risk that the transfer may not proceed. Following a successful ballot, the strategy may need to be refined in the light of information as it becomes available. The treasury management strategy should therefore facilitate the necessary potential degree of flexibility.

RECOMMENDATIONS

Members are asked to:

Approve the Treasury Management Strategy Statement and Annual Investment Strategy for 2007/08.