Report to: **Council**

Subject: **Treasury Management Strategy Statement and Annual Investment Strategy 2008/2009**

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PURPOSE OF REPORT

To seek Members' approval to the Council's Treasury Management Strategy Statement and Annual Investment Strategy for 2008/09.

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 (now DCLG) 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 2008/09 in respect of the following aspects of the treasury management function is based upon the Head of Corporate Service'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 2008/09 to 2010/11

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 2008/09 to 2010/11

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. Council approved these indicators on 27 February 2008. 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 2008 is detailed below:

	£	Av Rate %
Fixed Rate Borrowing - PWLB	**10,000,000**	4.07
Total Investments	**17,150,000**	5.58
Net Borrowing / (Investment)	**(7,150,000)**	

(4) Borrowing Requirement

The Council’s estimated borrowing requirement to finance its capital programme for the current year, 2007/08, and its anticipated requirements for the years 2008/09 to 2010/11 are detailed below. Due to favourable interest rates, borrowing in advance of cash flow need but within the capital financing requirement Prudential indicator, was undertaken during 2006/07, therefore the borrowing “requirement” differs to the actual borrowing undertaken.

	2007/08 £m	2008/09 £m	2009/10 £m	2010/11 £m
New Borrowing	0.5	0.0	0.0	0.0
Alternative Financing Arrangements	0.0	0.0	0.0	0.0
Total	**0.5**	**0.0**	**0.0**	**0.0**

(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 started on a downward trend from 5.75% to 5.5% in December 2007, to be followed by further cuts to 5.25% in Q1 2008, to 5% in Q2 2008, and to 4.75% in Q3 2008. It is then anticipated to be unchanged until an increase in Q4 2009 to 5%, and then unchanged for the remainder of the forecast period.. There is a downside risk to this forecast if inflation concerns subside and therefore open the way for the MPC to be able to make further cuts in the Bank Rate.

UK Economic Background:

- *Growth has been strong during 2007 and hit 3.3% year on year in Q3 and 2.9% in Q4 despite expectations of a significant slowdown in the pace of the economy. Growth is expected to cool to 2% in 2008.*

- *Higher than expected immigration from Eastern Europe has underpinned strong growth and dampened wage inflation.*

- *House prices started on the downswing in Q3 2007 and this is expected to continue into 2008.*

- *The combination of increases in Bank Rate and hence mortgage rates, short-term mortgage fixes expiring and being renewed at higher rates, food prices rising at their fastest rate since 1993, and increases in petrol prices, have all put consumer spending power under major pressure*

- *Banks have also tightened their lending criteria since the sub-prime crisis started and that will also dampen consumer expenditure via credit cards and on buying houses through obtaining mortgages.*

- *Government expenditure will be held under a tight rein for the next few years, undermining one of the main props of strong growth during this decade.*

- *The MPC is very concerned at the build-up of inflationary pressures, especially the rise in oil price to reach $90 to $100 per barrel from time to time (it was $30 in 2003), and the consequent likely effects on general prices. The prices of UK manufactured goods have risen at the fastest rate in 16 years in January 2008. Food prices have also risen at their fastest rate since June 2001, driven by strong demand from China and India. Consequently, the MPC is going to be much more cautious about cutting rates, compared to the Federal Reserve Bank in the USA, in the face of these very visible inflationary pressures. IN addition, UK growth was still strong in Q4 2007, despite* *expectations of a significant cooling off. The downward trend in Bank Rate is now expected to be faster than first thought after the initial cut in December 2007 to 5.5% in view of the MPC minutes which showed a unanimous vote for a cut, and consideration given to a 0.5% cut. This demonstrated how concerned the MPC is at the potential impact of the credit-crunch on the economies of the western world. However, the MPC's room for cutting rates is currently limited by concerns over inflationary pressures. If those pressures subside, then there is further downside risk to the Sector forecast which currently only allows for 0.25% cuts to reach 4.75% in Q3 2008.*

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 interest rates were successfully raised in order to cool their economies and to counter the build-up of inflationary pressures.*

- *The US is ahead of the UK and EU in the business cycle, and started on the downswing of the economic cycle during 2007. The Federal Reserve Rate peaked at 5.25% and was first cut in September by 0.5% to 4.75%. This was a response to the rapidly deteriorating prospects for the economy in the face of the downturn in the housing market, the sub-prime mortgage crisis and the ensuing liquidity crisis, which started in August 2007 and has subsequently resulted in banks making major write-offs of losses on debt instruments containing sub-prime mortgages. Banks have also tightened their lending criteria, which has hit hard those consumers with poor credit standing.*

- *The Federal Reserve cut its rate again, to 4.5%, in October 2007 and to 4.25% in December. A steep plunge in equity markets around the world in January 2008, precipitated by widespread concerns as to recession in the USA as a result of the sub-prime crisis and the unwinding of huge unauthorised positions taken by a rogue trader at the French bank Societe Generale, triggered an emergency "between meetings" cut of 0.75% by the Federal Reserve, followed by another cut of 0.5% at its regular meeting a few days later on 30 January.*

- *More cuts may be required to try to further stimulate the economy and to ameliorate the extent of the expected downturn. However, the speed and extent of these cuts may be inhibited by inflationary pressures, arising from oil prices and the falling dollar increasing the costs of imports. The US could be heading into stagflation in 2008, a combination of inflation and a static economy, but the economy could even slip into recession if the housing downturn becomes severe enough.*

- *The major feature of the US economy is a steepening downturn in the housing market, which is being undermined by an excess stock of unsold houses stoked by defaulting sub-prime borrowers pushed into forced sales. 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. Petrol prices have trebled since 2003 and, with similar increases in the price of home heating oil,* *this will also depress consumer spending with knock-on effects on house building, employment etc.*

- *The downturn in economic growth in the US in 2008 will depress world growth, especially in the western economies, which will also suffer directly under the impact of high oil prices However, strong growth in China and India will partially counteract some of this negative pressure.*

- *EU growth has been strong during 2006 and 2007 but will be caught by the general downturn in world growth in 2008.*

(6) Borrowing Strategy

Sector's view on the borrowing strategy is as follows. These forecasts are based around an expectation that there will normally be variations of +/-25 basis points during each quarter around these average forecast in normal economic and political circumstances. However, greater variations can occur should there be any unexpected shocks to financial and/or political systems.

- *The 50-year PWLB rate is expected to fall marginally from 4.50% in Q1 2008 to 4.45% in Q2 2008, before rising back again to 4.50% in Q2 2009, to eventually reach 4.65% in Q2 2010.*

- *The 25-30 year PWLB rate is expected to fall from 4.55% to 4.50% in Q2 2008 and then to rise in gradual steps from Q2 2009 to reach 4.75% in Q3 2010.*

- *The 10-year PWLB rate is expected to fall from 4.60% in Q1 2008 to 4.55% in Q2, and to 4.50% in Q3 2008. It is then expected to rise gradually from Q1 2009 to reach 4.85% in Q3 2010.*

- *The 5-year PWLB rate is expected to fall from 4.55% in Q2 2008 to 4.50% in Q3 2008 and to then gradually rise from Q1 2009 to reach 4.85% in Q2 2010.*

This forecast indicates, therefore, that there is a range of options available for borrowing strategy for 2008/09. Variable rate borrowing is expected to be more expensive than long-term borrowing, and will therefore be unattractive throughout the financial year compared to taking fixed rate borrowing. There is expected to be very little difference between 5-year to 50-year PWLB rates, so this may open up a range of choices for new borrowing for authorities that wish to spread their debt maturities away from a concentration in long-dated debt. There is also expected to be little variation in rates during the year, so borrowing could be undertaken at any time in the year.

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

- *For authorities wanting to focus on the very cheapest PWLB borrowing, the 50-year borrowing will provide marginally cheaper rates than 25-30 year borrowing. As little variation is expected during the year, borrowing could be undertaken at any the in the year.*

- *However, despite the minimally more expensive new borrowing rates expected in the 25-30 year period, these could be seen as being much more attractive than 50-year borrowing as the spread between the PWLB new borrowing and early repayment rates is considerably less. This then maximises the potential for debt rescheduling at a later date by minimising the spread between these two rates.*

- *This strategy would also mean that after some years of focusing borrowing at or near the 50-year period, local authorities would be able to undertake borrowing in a markedly different period and so to achieve a better spread in their debt maturity profile.*

- *There is expected to be little difference between PWLB rates in the 5-30 year range, so consideration will also be given to creating a greater spread of maturities in the debt portfolio by taking new borrowing at shorter periods.*

- *When PWLB rates fall back to the central forecast rate of about 4.50%, borrowing should be undertaken at any time during the financial year. A suitable trigger point for considering new fixed rate long-term borrowing would be 4.50%. The central forecast rate will be reviewed in the light of movements in the slope of the yield curve, spreads between PWLB new borrowing and early payment rates, and any further changes that the PWLB may introduce to their lending policy and operations.*

- *Consideration will also be given to borrowing market loans, including vanilla LOBOs (Lender Option, Borrower Option), at 25-50 basis points below the PWLB target rate.*

Against this background, caution will be adopted with the 2008/09 treasury operations. The Head of Corporate Services 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 borrowing will be postponed, and potential rescheduling from fixed rate funding into short term funding will be considered.

(7) Debt Rescheduling

The introduction on 1 November 2007 of different PWLB rates for new borrowing as opposed to the early repayment of debt, and the setting of a spread between the two rates (of about 40-40 basis points for the longest period loans, narrowing down to 25-30 basis points for the shortest loans), has meant that PWLB to PWLB debt restructuring is now much less attractive than before that date. However, significant interest savings will still be achievable through using LOBOs (Lender Option Borrower Option) loans and other market loans.

As average PWLB rates in some maturity periods are expected to be minimally higher at the start of the financial year than later on in the year, and as Bank Rate is expected to fall significantly, this means that the differential between long and short rates will narrow during the year and that there should therefore be greater potential for making interest rate savings on debt by doing debt restructuring earlier on in the year.

Any positions taken via rescheduling will be in accordance with the strategy position outlined in paragraph 6 above.

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)

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

(8) Annual Investment Strategy

(8.1) Investment Policy

Investment Principals

The Council will have regard to the ODPM (now DCLG) 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 2008/09 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 Corporate Services 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.

<u>Specified and Non-Specified Investments</u>

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

<u>Investments defined as capital expenditure</u>

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 2008 the Council does not hold any investments spanning the whole of the financial year 2008/09, ie. maturing beyond 31 March 2009.

Interest Rate Outlook

The Bank Rate started on a downward trend from 5.75% with the first cut to 5.5% I December 2007. This is forecast to continue with further cuts to 5.25% in Q1 2008, 5% in Q2 and4.75% in Q3 2008. It is then expected to rise back to 5% in Q4 2009 and stabilise there for the foreseeable future. The Council should therefore seek to lock into longer period investments at higher rates ahead of these cuts for some of that 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 2008/09, Sector recommends that the Council should budget for an investment return of 4.90% to 5% on investments placed during 2008/09. Given the Council's current portfolio together with its assumptions for the forthcoming year, the overall estimated equated rate assumed in the revenue budgets for 2008/09 is 5.19%.

The Council has identified 5.2% as a minimum investment level for 1-year lending, 5.3% for 2-year lending and 5.35% for 3-year lending. The minimum investment levels will be kept under review, and discussed with Sector in order that investments can be made at the most 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 continues to raise a number of complex and critical issues, which will need to be considered and planned for in advance of the physical transaction, which is anticipated to take place during 2008/09. Following a revised stock condition survey there will not now be a capital receipt, and “Gap Funding” of around £13m has been agreed by DCLG.

The positioning and structure of borrowing during 2008/09 will need to be considered in the light of the LSVT 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 2008/09.