CITY OF
YORK
COUNCIL

Executive **12th February 2008**

Report of the Director of Resources

Treasury Management Strategy Statement and Prudential Indicators for 2008/09 to 2011/12

Purpose

1. The purpose of this report is to ask the Executive to recommend that Council approve:

    - an integrated Treasury Management Strategy Statement including the annual investment strategy;
    - the proposed Prudential Indicators for 2008/09 to 2011/12;
    - the use of the revised Treasury Management Policy and the Treasury Management Practices.

Summary

2. The report provides a background to why it is necessary to produce a Treasury Management Strategy and set prudential indicators for the following three years.

3. The Treasury Management in the Public Services Code of Practice recommends that, Local Authorities annually review and update where necessary their Treasury Management Policy Statement and Practices. These documents, revised for the 2008/09 financial year, are attached in Annex D and E.

4. The Council is currently undertaking a series of significant capital schemes that will realise revenue savings over the following 30 years. This high level of upfront capital investment will see the Council's underlying need to borrow rise from the current level of approximately £10m per annum to almost £30m in 2009/10. The borrowing strategy aims to minimise the risks to the Council of borrowing large amounts in a single year by giving the Council the flexibility to borrow in advance of need, in order to take advantage of favourable interest rates as they arise.

5. The annual investment strategy reviews the projected interest rates over the next 3 years until the 2010/11 financial year, and seeks to maximise the returns to the Council whilst minimising the risks involved in placing deposits on the money market.

Background

6. The Local Government Act 2003 requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy that sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

7. As part of the strategy, the Local Government Act 2003 also requires the Council to 'have regard to' the CIPFA[1] Prudential Code and to set Prudential Indicators for a minimum of the next three years to ensure the Council's capital investment plans are affordable, prudent and sustainable. The strategy therefore is affected by the Council's capital spending plans, as set out in the Capital Budget report and the revenue implications of these that are reflected in the Revenue Budget report, both o this agenda.

8. The suggested strategy for 2008/09 in respect of the following aspects of the treasury management function is based upon the Director of Resources views on interest rates, supplemented with market forecasts provided by Sector, the Council's treasury management advisors. The strategy covers:

    - Treasury limits in force which will limit the treasury risk and activities of the Council (paragraph 12 -13);
    - Prudential Indicators (paragraph 14 – 15 and Annex A);
    - The current treasury position (paragraph 16 -19);
    - Prospects for interest rates (paragraph 20 - 21);
    - The borrowing requirement and strategy (paragraph 23 - 30);
    - Debt rescheduling (paragraph 31 - 34);
    - The investment strategy (paragraph 35 -40).

Consultation and Options

9. The treasury management function of any business is a highly technical area, where decisions are often taken at very short notice in reaction to the financial markets. Therefore, to enable effective treasury management, all operational decisions are delegated by the Council to the Head of Finance, who operates within the framework set out in this strategy and through the Treasury Management Policies and Practices. In order to inform sound treasury management operations the Council works with its Treasury Management advisors, Sector Treasury Services. Sector offer the Council a comprehensive information and advisory service to enable the Council to maximise its investment returns and minimise the costs of its debts.

10. Treasury Management activity is influenced by the capital investment and revenue spending decisions made by the Council. Both the revenue and capital budgets have been through a corporate process of consultation and consideration by the elected politicians.

[1] Chartered Institute of Public Finance and Accountancy (CIPFA)

11. At a strategic level, there are a number of treasury management options available which depend on the Council's stance on interest rate movements. This report sets out the Council's stance and recommends the setting of key trigger points for borrowing and investing over the forthcoming financial year.

Analysis

Treasury Limits 2008/09 –2011/12

12. 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 "Authorised Borrowing Limit", and is the absolute maximum level of debt the Council is permitted to take. However, within this limit there is an "Operational Borrowing Limit", which is the maximum level of debt allowed for on going operational purposes. In reality the operational limit would only be breached as a result of in year cash flow movements or if there was an opportunity to borrow at exceptionally low interest rates.

13. The Council must have regard to the Prudential Code when setting the Authorised and Operational Limits for external debt, which essentially requires the Council to ensure that total capital investment financed by debt remains within sustainable limits and, in particular, that the impact upon its future council tax and council rent levels is 'acceptable'. Both the operational limit and authorised limit have been reviewed in light of the capital investment plans, as set out in the capital programme, and rebased for 2008/09. They now stand at £119m and £129m respectively. External debt includes conventional borrowing and other forms of liability, such as credit arrangements. Both limits are set on a rolling basis for the forthcoming financial year and two successive financial years in line with the Councils 3 year capital programme.

Prudential Indicators

14. The Council is required by regulation to have regard to the Prudential Code when carrying out its duties under the Local Government Act 2003. The key objectives of the Prudential Code are to ensure, within a clear framework, that local authorities' capital investment plans are affordable, prudent and sustainable; that treasury management decisions are taken in accordance with good professional practice; and that local strategic planning, asset management planning and proper option appraisal are supported. Annex A illustrates the Prudential Indicators for 2008/09 to 2010/11 with a description of what each indicator represents.

15. The Prudential Indicators help drive the treasury management strategy and annual investment strategy. The paragraphs below take account of additional factors that need to be taken into consideration when formulating the treasury strategy.

Current Debt Portfolio Position

16. The Council is only permitted to borrow in to invest in capital projects, unless permitted to do otherwise by the Government. Therefore the majority of the Councils existing debt is secured against its asset base. The Council currently has £99.4m of fixed interest rate debt with an average life of loan of 16 years and average cost of debt of 4.64%. The Council's current long term borrowing position as 7 January 2008 is shown in Table 1.

Institution Type	Principal	Average Rate
Public Works Loan Board (PWLB) – Money borrowed from the Debt Mgt Office (Treasury Agency)	**£89.4m**	**4.57%**
Market Loan – A single loan which the Council has been unable to exit from	**£10.0m**	**7.155%**

Table 1 – Fixed Term Borrowing

17. Figure 1 shows the Councils projected debt maturity structure as at April 2008.

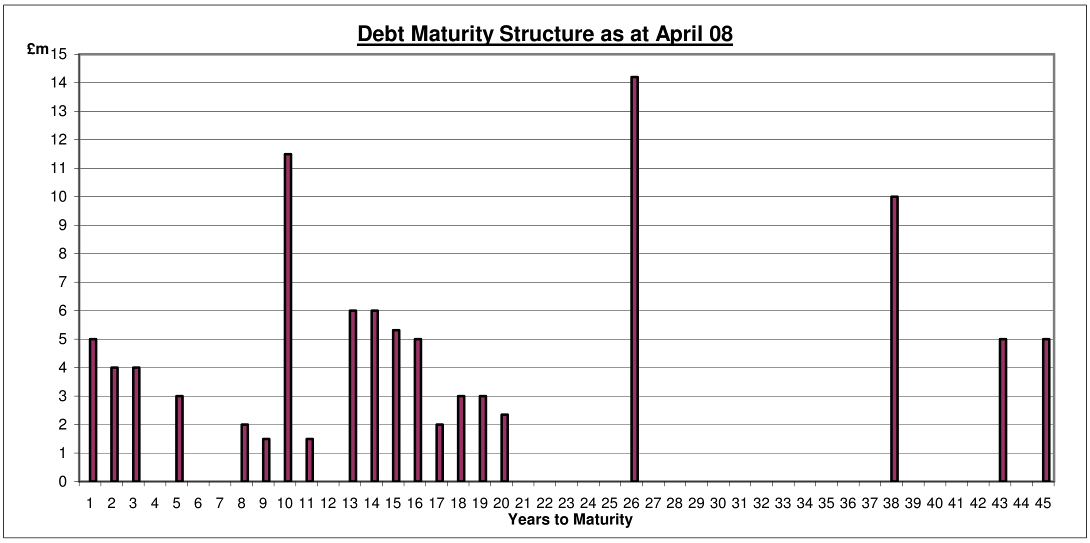

Figure 1 – Debt Maturity Profile as at April 2008

18. The Council currently has no variable rate borrowing.

Investments

19. The Council's total investments at 7 January 2008 were £71.85m of which £15.85m were held in instant access call accounts with the remaining £56.0m being invested in fixed term deposits on the UK money market.

Prospects for Interest Rates

20. Current interest rates and the future direction of both long term and short term interest rates have a major influence on the overall treasury

management strategy and affects both investment and borrowing decisions. To facilitate treasury management officers in making informed investment and borrowing decisions the Council contracts Sector Treasury Services as its treasury advisors. Part of their service is to assist the Council in formulating a view on interest rates. Annex B draws together a number of current City forecasts for short term interest rates (base rate) and longer term fixed interest rates. Sectors view of fixed long term borrowing rates (PWLB) and the base rate are shown in Figure 2.

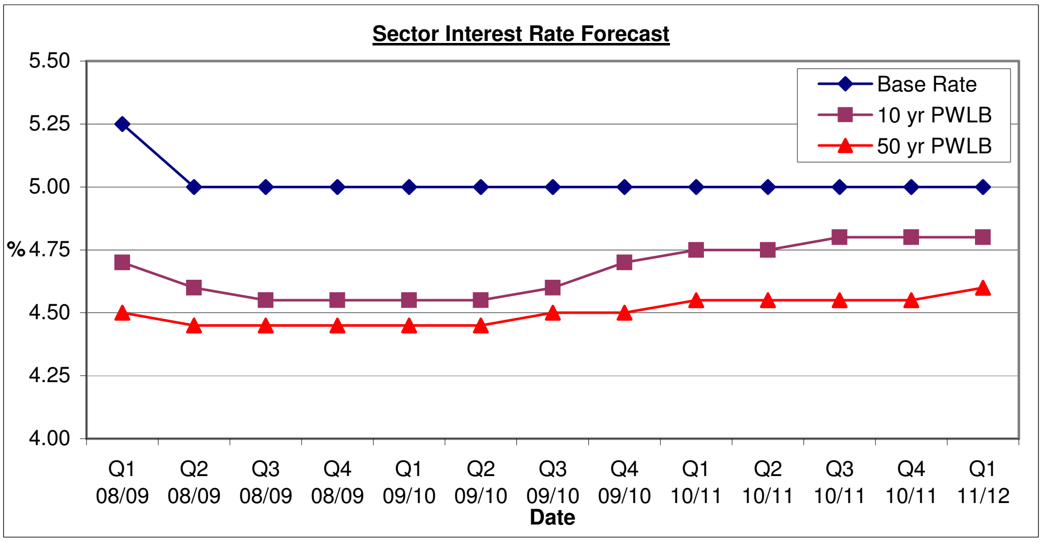

Figure 2 – Sector interest rate forecast

21. Following three changes in the 2007/08 financial year the Bank of England base rate is currently at 5.50% having started the financial year at 5.25%. May and July saw 0.25% increases in each month with a decrease down to the current rate of 5.50% in December. Forecasts for the forthcoming financial year and beyond are looking at further reductions in the Bank of England base rate with the first due by March 2008 which would take the base rate down to 5.25%. Forecasters are then suggesting rates will fall to 5.0% in the first quarter of the 2008/09 financial year. Although it is anticipated that interest rates will remain at 5.0% throughout the 2008/09 financial year, there is a downside risk from quarter 3 of 2008/09 (this suggests that interest rates could go as low as 4.75%).

Economic background

22. The interest rate forecasts must be set against the economic background in both the UK and the rest of the world:

UK

a. Gross Domestic Produce (GDP): growth has been strong during 2007 and hit 3.2% year on year in Q3. However growth is expected to cool from 3.0% in 2007 as a whole to 2.0% in 2008.

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

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

d. The combination of increases in the base 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.

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

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

g. The Bank of England's Monetary Policy Committee (the body responsible for controlling the rate of inflation through setting interest rates) is very concerned at the build up of inflationary pressures especially the rise in the oil price to $90 – 100 per barrel ($30 in 2003) and the consequent likely knock on effects on general prices. The prices of UK manufactured goods have risen at the fastest rate in 16 years in November 2007 – 4.5%. Food prices have also risen at their fastest rate for fourteen years (6.6% annual increase) driven by strong demand from China and India. Consequently, the MPC is going to be much more cautious about cutting rates compared to the US Central Bank (the Federal Reserve) in the face of these very visible inflationary pressures. In addition, UK growth was still exceptionally strong in Q3, as has also been the growth in the money supply. The downward trend in the Bank of England base rate is therefore expected to be slow, after the initial cut in December 2007 to 5.50%, to eventually reach 5.0% in Q1 of 2008/09 financial year.

International

h. 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 successively raised in order to cool their economies and to counter the build up of inflationary pressures.

i. The US is ahead of both the UK and EU in the economic cycle and started on the downswing during 2007. The Federal Reserve (Fed) 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. This has subsequently resulted in banks making some 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.

j. The Fed cut its rate again, to 4.5% in October 2007 and to 4.25% in December and is expected to cut by between another 0.25% to 0.75% by April 2008 to try to stimulate the economy and to ameliorate the extent of the downturn. However, the speed and extent of these cuts will be inhibited by inflationary pressures arising from oil prices, the falling dollar increasing the costs of imports, etc. The US could well be heading into stagflation in 2008 – a combination of inflation and low or negative economic growth. The economy could even tip into recession if the housing downturn becomes severe enough.

k. 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 and employment.

l. 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, it is anticipated strong growth in China and India will partially counteract some of this negative pressure.

m. EU growth was strong during 2006 and 2007 but will be caught by the general downturn in world growth in 2008.

Borrowing Strategy

23. Historically the Council has needed to borrow between £10m and £12m a year to finance its capital programme. This level of borrowing is the level at which the Government provide support through grant funding to cover the cost of interest payments and debt repayment. The Council intends to borrow above the level supported by Government grant funding in future years taking advantage of the Prudential Code (introduced April 2004) which allows Local Authorities to determine their own programmes for capital investment so long as the plans are affordable, prudent and sustainable. The main reason for the increase in unsupported borrowing is large scale investment in major assets that will result in long term revenue savings to the Council. The key projects are:

    a. The Administrative Accommodation Rationalisation Project (£25.25m borrowing requirement)

    b. The financing of replacement IT equipment using prudential borrowing as opposed to leasing, resulting in the Council owning the asset (£8.0m borrowing requirement over 4 years)

c. Investment in the York Pools Strategy (£1.5m borrowing requirement)

d. Investment in York High School (£1.3m borrowing requirement).

24. As a result of these projects the need to borrow is projected to increase from £10m a year in 2007/08 to £27m in 2009/10, with overall net debt increasing by £61m by 2010/11. Borrowing during the year in which the funds are required would be a risky strategy for two reasons:

    a. The Council would be vulnerable to a rise or spike in interest rates especially in a year such as 2009/10 when the borrowing requirement will be over £27m.

    b. The Government reserve the power to impose a restriction on the amount of prudential borrowing that a Council can take if the economic environment dictates.

25. The treasury management and borrowing strategy needs to reflect this position and seek to minimise the risk of being required to borrow a large amount of money in a single year. The strategy therefore allows borrowing to be taken in advance of need if interest rates are at favourable levels.

26. Interest rate forecasts, shown in paragraph 21 (Figure 1), predict long term PWLB rates (50 year borrowing rates) to be in the 4.45% to 4.60% range over the next three financial years. This is a single figure indicator and the central forecasts can fluctuate between +/- 0.25%, meaning rates could go as low as 4.20% or as high as 4.85%. Capital Economics (a leading financial forecasting firm) have forecast 50 year PWLB rates going as low as 4.25% in the 2008/09 financial year with UBS (a leading financial analyst firm) forecasting rates to be at a low point of 4.60% during the same period.

27. Variable rate borrowing and short term borrowing (5 year PWLB) are expected to be more expensive than long term borrowing with the 5 year PLWB low point forecast to be 4.55% making it comparatively unattractive.

28. In light of these projections the proposed Council strategy is as follows:

    - With 50 year PWLB forecast to be at 4.45% borrowing should be made around this duration at any time in the year. This period is the cheapest on the borrowing curve with 5 year, 10 year and 25 year PWLB being at lows of 4.55%, 4.55% and 4.50% respectively. A suitable trigger point for considering PWLB long term fixed rate borrowing would be 4.30%, significantly below the Council's long term costs of funds of 4.64%.

29. Caution in this approach will be adopted with the Head of Finance monitoring interest rates and ensuring a pragmatic approach is taken to

changing circumstances reporting any decisions as part of the Corporate Services EMAP monitoring cycle.

30. The main sensitivities of the forecast are likely to be the two scenarios below. The Treasury Management team in conjunction with the treasury advisors, will continually monitor both the prevailing interest rates and the market forecasts, adopting the following responses to a change of sentiment:

- if it were felt that there was a significant risk of a sharp rise in long 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 re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

- if it were felt that there was a significant risk of a sharp fall in long and short term rates, due to e.g. growth rates weakening, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term funding will be considered.

Debt Rescheduling

31. The introduction of different PWLB rates on 1 November 2007 for new borrowing as opposed to early repayment of debt, and the setting of a spread between the two rates (of about 40 – 50 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 for the Council than before that date. However, significant interest savings will still be achievable through using LOBOs (Lenders Option Borrowers Option) loans and other market loans.

32. As average PWLB rates are expected to be marginally higher at the start rather than later in the financial year, and as the base rate is expected to fall more than longer term borrowing rates, this will mean that the differential between long and short term rates will narrow, implying that there will be greater potential for making interest rate savings on debt by debt restructuring earlier on in the year.

33. The reasons for any rescheduling to take place will include:

    a. the generation of cash savings and / or discounted cash flow savings;

    b. enhancing the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

34. Any rescheduling will be reported to Corporate Services EMAP as part of the monitoring cycle.

Investment Strategy

35. 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"). The Council's investment priorities are the security of capital and the liquidity of its investments. The Council also aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

36. The borrowing of monies specifically to invest or lend on and make a return is unlawful and the Council will not engage in such activity.

37. Investment instruments identified for use in the financial year are listed in Annex C - Specified and Non-Specified Investments categories. Counterparties limits will be as set through the Council's Treasury Management Practices Schedule.

38. The Council's in-house funds are mainly cash flow derived. Investments will accordingly be made with reference to the core balance, cash flow requirements and the outlook for short-term interest rates. The Council uses matrices that stipulate both time and financial limits in order to spread counterparty (credit) risk when investing money with approved counterparties.

39. Sector is forecasting that the base rate has now started on a downward trend following the cut from 5.75% to 5.50% in December 2007, they anticipate that interest rates will be at 5% by the start of 2009 and remain at this level for the foreseeable future (until Q4 2010/11). The Council should, therefore, seek to lock some element of the investment portfolio which represents the core balances in to longer period investments at higher rates before this fall starts.

40. For its cash flow generated balances, the Council will seek to utilise short dated fixed term deposits along with instant access business reserve accounts in order to benefit from the compounding of interest.

Corporate Priorities

41. The Treasury Management Strategy Statement and Prudential Indicators are aimed at ensuring the Council maximises its return on investments and minimises the cost of its debts, to allow more resources to be freed up to invest in the Council's priorities, values and imperatives, as set out in the Corporate Strategy.

Implications

- **Financial** – The revenue implications of the treasury strategy are set out in the Revenue Budget report on this agenda.

- **Human Resources (HR)** – None

- **Equalities** – None
- **Legal** – Complying with the Local Government Act 2003
- **Crime and Disorder** – None
- **Information Technology (IT)** – None
- **Property** – None

Risk Management

42. The treasury management function is a high risk area because of the volume and level of large money transactions. As a result of this there are strict procedures set out as part of the Treasury Management Policy and Treasury Management Practices Statement which are set out in Annex D and E respectively.

Recommendations

43. The Executive are asked to recommend that Council approve:
    a. The Prudential Indicators for 2008/09 to 2010/11 (Annex A);
    b. The proposed Treasury Management Strategy for 2008/09 –2010/11;
    c. The revised Treasury Management Policy and Treasury Management Practices (Annexes D and E).

44. Reason: To enable the continued effective operation of the Treasury Management function and ensure that all Council borrowing is prudent, affordable and sustainable.

Contact Details

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Director of Resources

Report Approved		**Date**	

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Director of Resources

Report Approved	Y	**Date**	11/1/08

Specialist Implications Officer(s)

N/a

Wards Affected: **All** Y

For further information please contact the author of the report

Background Papers
2007/08 monitoring working papers and respective EMAP reports.
Sector Treasury Services Limited

Annexes
Annex A – Prudential Indicators 2008/09 – 2010/11
Annex B – Interest Rate Projections
Annex C – Specified and Non-Specified Investments
Annex D – Treasury Management Policy
Annex E – Treasury Management Practices