CITY OF YORK COUNCIL

Executive **16 February 2009**

Report of the Director of Resources

Treasury Management Strategy Statement and Prudential Indicators for 2009/10 to 2013/14

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 2009/10 to 2013/14;
   - 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 five 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 2009/10 financial year, are attached in Annex C and D.

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 contributes to the rise in the Council's underlying need to borrow from the current level of approximately £102m in 2008/09 to over £146m in 2013/14. 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 2011/12 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 (as required by Investment Guidance issued subsequent to the Act) (included as paragraph 9) 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 on this agenda. As the Capital Budget is now based over 5 years the set Prudential Indicators will be set over the matching time period for completeness.

8. The suggested strategy for 2009/10 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);
    - Current treasury position (paragraph 16-19);
    - Prospects for interest rates (paragraph 20 -22);
    - Borrowing requirement and strategy (paragraph 23 -30);
    - Debt rescheduling (paragraph 30 -33);
    - Investment strategy (paragraph 34 -40);
    - Minimum Revenue Provision strategy (paragraph 41 -45).

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

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

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. The revenue budget and capital budget proposals are included within this agenda.

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 2009/10 –2013/14

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. 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 if the future underlying need to borrow supported this.

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 2009/10. They now stand at £145m and £186m 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 four successive financial years in line with the Councils 4 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 Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. This was adopted on 21 February 2008by the full Council. 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 2009/10 to 2013/14 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 £102.065m of fixed interest rate debt with an average life of loan of 21 years and average cost of debt of 4.55%. The Council's current long term borrowing position as 8 January 2009 is shown in Table 1.

Institution Type	Principal	Average Rate
Public Works Loan Board (PWLB) – Money borrowed from the Debt Mgt Office (Treasury Agency)	**£87.065m**	**4.509%**
Market Loans Club Loan – A loan taken in conjunction with 2 other Authorities LOBO Loan – Lender Option Borrower Option	**£10.0m** **£5.0m**	**7.155%** **3.880%**

Table 1 – Fixed Term Borrowing

17. Figure 1 shows the Councils projected debt maturity structure as at April 2009.

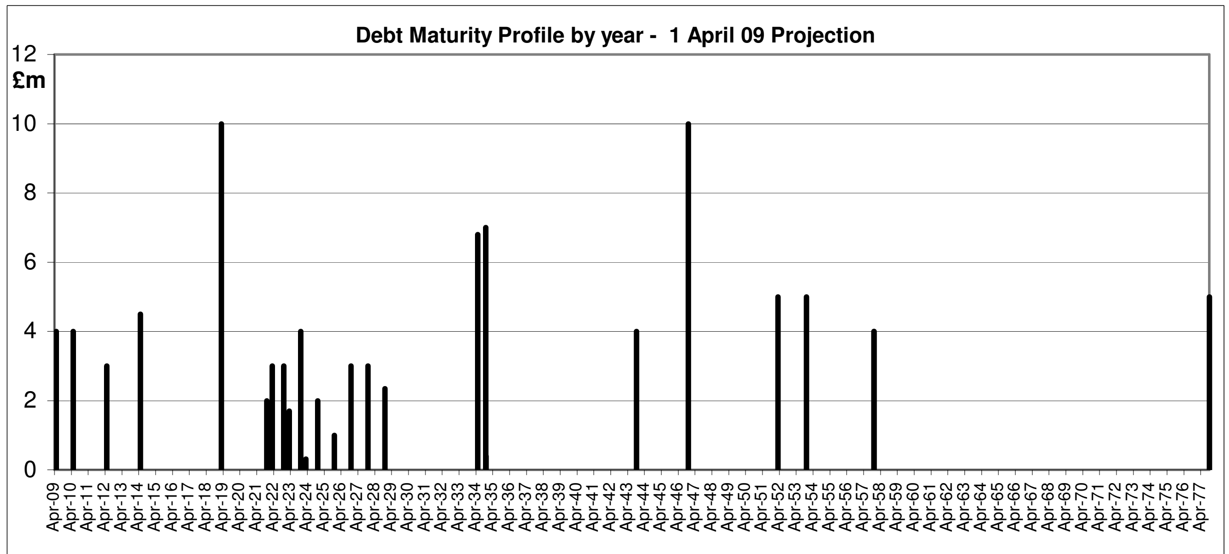

Figure 1 – Debt Maturity Profile as at April 2009

18. The Council currently has no variable rate borrowing.

Current Investments

19. The Council's total investments at 8 January 2009 were £64.950m of which £8.950m 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. Sectors view of fixed long term borrowing rates (PWLB) and the base rate are shown in Figure 2.

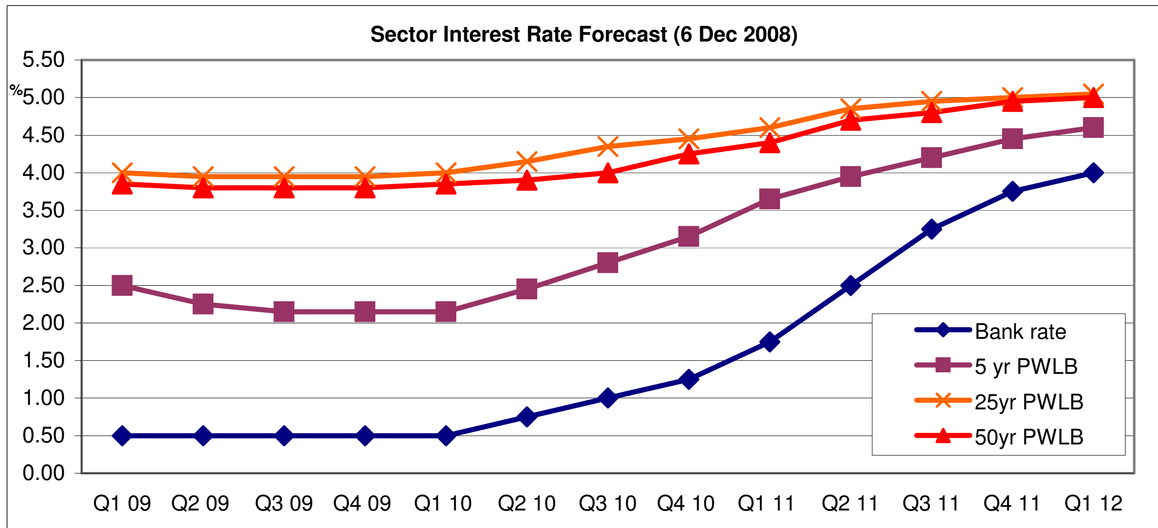

Figure 2 – Sector interest rate forecast

21. The sub prime crisis of early 2008 was replaced by the banking crisis of autumn 2008. The world banking system came near to collapse and governments around the world were forced to recapitalise and rescue their major banks. The resulting restricted lending from banks anxious to preserve capital led to economic forecasts being sharply reduced and recession priced into markets. This in turn led to sharp falls in oil and other commodity prices with the result that inflation, which in the UK was running at over 5%, became a background issue and recession fears drove interest rate sentiment and policy. A co-ordinated global interest rate cut of 50bp took place on 8th October 2008. Forecasts in the UK were for further sharp cuts in interest rates as recession hove into view.

Economic background

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

UK

a. Gross Domestic Product (GDP): growth was already slowing in 2008 from 2007 before the full impact of the credit crunch was felt. Earlier in 2008 GDP was 2.3% whereas in the autumn the figure fell back to -0.3% and was then expected to continue to be negative going into 2009.

b. Wage inflation remained relatively subdued as the Government kept a firm lid on public sector pay. Private sector wage growth was kept in check by the slowing economy.

c. Growth slowed across the economy and unemployment rose throughout the year with forecasts of 2 million unemployed by the end of the financial year and continuing to increase thereafter through 2010.

d. Bank lending came to a virtual standstill in the autumn as the credit crunch tightened its grip and various banks internationally had to be rescued, or supported, by their governments.

e. The Government and Bank of England supplied significant amounts of liquidity to the banking market in an attempt to reignite longer interbank lending.

f. The Government took action in September to either supply finance itself to recapitalise some of the major clearing banks or to require the others to strengthen their capital ratios by their own capital raising efforts. This was so that these banks would be seen to have sufficient reserves to last through the coming recession with its inevitable increase in bad loans etc.

g. The housing market also came to a virtual standstill as lenders demanded larger deposits and higher fees. House sales and prices both dropped sharply.

h. Government finances deteriorated as income from taxation dropped as the economy slowed and the cost of the bailout of the banks was added to the deficit.

i. U.K. equity prices declined sharply in the 3rd and 4th quarters as the impending recession was priced into the markets. Prices hit five year lows and volatility was extremely high.

j. The story of 2008 has been the credit crunch, the banking crisis and the change in economic outlook from slow growth to outright recession. After the initial concerns about the impact of the credit crunch in the earlier part of 2008 it appeared as though the storm had been weathered. The Monetary Policy Committee (MPC) had been very concerned about CPI inflation, which had been rising sharply on the back of higher commodity and food prices. Bank Rate reached a peak of 5.75% in July 2007 after which cuts of 0.25% occurred in December 2007 and February and April 2008 before the major cuts in the autumn. The economic data had been indicating a slowing economy for some while but it was not sufficiently weak to force the MPC into another cut. It was the strength of the banking crisis, pre-empted by the collapse of Lehmans in New York that eventually drove the MPC to cut interest rates by 50bp on October 8th in concert with the Federal Reserve, the ECB and other central banks. It was then appreciated that the economic downturn would be much more severe than previously thought and interest rates were subsequently slashed by 150bps on 6 November, 100bps on 4 December and 50 bps on 8 January 2009.

k. The LIBOR (London Inter Bank Offer Rate) spread over Bank Rate has also been a feature, and a concern, of 2008/9. Because of the credit fears and the reluctance of lenders to place cash for long periods 3 month LIBOR has been substantially higher than Bank Rate. This has meant that the MPC's power over monetary policy has been eroded by the widening of this spread between LIBOR and Bank Rate and it has

therefore had a limited ability to bring relief to hard pressed borrowers through lower interest rates. However, the power of the Government over the semi nationalised clearing banks had considerable impact in enforcing pro rata reductions to the 150 bps Bank Rate cut in November on some borrowing rates.

l. The Government has abandoned its 'golden rule'. The pre Budget Report on 14 November revealed the Government's plans for a huge increase in Government borrowing over coming years as a result of falling tax revenues and also due to tax cuts and increases in Government expenditure in the short term designed to help stimulate economic growth to counter the recession.

International

m. Early in 2008 the US economy was being badly affected by the housing market slump. Interest rates were at 2% and inflation was being dragged higher by the inexorable rise in commodity prices. The ECB was very concerned about rising inflation and less about the state of the economy.

n. The second quarter of 2008/9 was torn between inflation worries on the one hand, with oil rising towards $150 per barrel, and the deteriorating economic outlook on the other.

o. In the second and third quarters of the year the financial crisis erupted and escalated as the world became aware of the extent of the sub-prime fiasco and the impact it was having on institutions that had invested in these issues.

p. In September Fannie Mae/Freddie Mac (the mortgage banks) and AIG, the insurance giant, had to be bailed out by the US Federal Government.

q. Then in mid September, Lehman Bros., the investment bank, was allowed to fail. This triggered a domino effect with other banks and financial institutions having to be rescued or supported by governments around the world.

r. After the collapse into receivership of the Icelandic banks in early October, other countries then started to feel the strain and a number had to approach the International Monetary Fund for support.

s. Eventually even the Asian 'Tiger' economies were affected, including India and China, and it became clear that the crisis had become a global one and no country was insulated from it.

t. The financial crisis had therefore precipitated an economic crisis and there was a co-ordinated global interest rate cut with the Fed, ECB and MPC all cutting rates by 50bp on 8th October. The Fed subsequently cut rates again by 50bp to 1% on 29th October and again on 16 December to a band of 0.0% to 0.25% in an attempt to stave off the oncoming recession. Inflation was yesterday's problem.

u. The ECB reduced rates again on 6th November by 50bp and by its biggest ever cut of 75bp on 4 December to reach 2.5%.

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 (£26m borrowing requirement)

    b. The financing of replacement IT equipment using prudential borrowing as opposed to leasing, resulting in the Council owning the asset (£6.0m borrowing requirement over 4 years)

    c. Investment in the York Pools Strategy (£500k borrowing requirement)

    d. Investment in York High School (£400km borrowing requirement).

24. As a result of these projects the borrowing requirement is projected to increase significantly from its current level of £102m a year in 2008/09 to £146m in 2013/14. 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 2010/11 when the borrowing requirement will be over £17m.

    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. The Sector forecasts are as follows and based around an expectation that there will normally be variations of +/- 25bp during each quarter around these average forecasts in normal economic and political circumstances. However it should noted that greater variations can occur should there be

any unexpected shocks to financial and/or political systems. These forecasts are for the PWLB new borrowing rate:

- The 50 year PWLB rate is expected to remain around current levels of about 3.95 % until Q2 2010 when it is forecast to rise to 4.00%. The rate then edges up gradually to reach 5.00% at the end of the forecast period (Quarter 1 2012).

- The 25 year PWLB rate is expected to drop to 3.95% in Q1 2009 and stay around there until starting to rise in Q1 2010 and then to eventually reach 5.05% at the end of the forecast period.

- The 10 year PWLB rate is expected to drop to 2.55% in Q3 2009 but then to start rising again in Q2 2010 to eventually reach 4.85% at the end of the forecast period.

- The 5 year PWLB rate is expected to fall to a floor of 2.15% during Q3 2009. The rate then starts rising in Q2 2010 to eventually reach 4.60% at the end of the forecast period.

26. Variable rate borrowing is expected to be cheaper than long term borrowing and will therefore be attractive throughout the financial year compared to simply taking long term fixed rate borrowing. Variable rate borrowing will however only bring short term benefit and increase the risk to the Council of refinancing debt at a future date when it is forecast for rates to be at a higher level.

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

- With medium to long term borrowing (25 - 50 year PWLB) forecast to be at the 3.95% level borrowing should be made around this duration at any time in the year. This period is not the cheapest on the borrowing curve with 5 year and 10 year being lower but it is does enable the Council fund long life assets (land and buildings) at a levels of sub 4% thus ensuring long term benefit of the currently low rates. A suitable trigger point for considering PWLB long term fixed rate borrowing would be 3.95%, significantly below the Council's long term costs of funds of 4.55%.

28. Caution in this approach will be adopted with the Director of Resources monitoring interest rates and ensuring a pragmatic approach is taken to changing circumstances reporting any decisions as part of the monitoring cycle.

29. 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

30. 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 loans and other market loans (note commercial markets are not currently fully operational thus decreasing the likelihood of debt restructures).

31. 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.

32. 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).

33. Any rescheduling will be reported in accordance with the usual monitoring cycle.

Investment Strategy

34. 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.

35. 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.

36. Investment instruments identified for use in the financial year are listed in Annex B - Specified and Non-Specified Investments categories. Counterparties limits will be as set through the Council's Treasury Management Practices Schedule. Consideration will be given throughout the year and approval requested where necessary to the alteration of the specified and non-specified investment categories to allow the continued effective management of the Councils treasury management operations. The Council continues to take a prudent approach to investing funds using credit ratings from Moody and Fitch to determine acceptable value and duration limits.

37. 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.

38. The Bank Rate started on a downward trend from 5.75% in December 2007 with an initial cut of 0.25% with further cuts of 0.25% in February and April 2008, then 0.5% in October, 1.5% in November, 1% in December and 0.5% in January 2009. Further cuts of 1.0% are expected during Q1 2009. It is then expected to stabilise at 0.50% until starting to rise gradually with the first increase in Q2 2010 and then to be back up to 4.00% during Q1 2012. The Council should therefore avoid locking into longer term deals while investment rates are down at historically low levels.

39. 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.

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

Minimum Revenue Provision (MRP) Strategy

41. Statutory Instrument 2008 no. 414 s4 lays down that a local authority shall determine for the current financial year an amount of minimum revenue provision that it considers to be prudent. This is a substitution for the previous requirement to comply with regulation 28 in S.I. 2003 no. 3146, (as amended).

42. Along with the above duty, the Government issued new guidance in February 2008 which requires that a Statement on the Council's policy for its annual MRP should be submitted to the full Council for approval before the start of the financial year to which the provision will relate.

43. The Council are legally obliged to “have regard” to the guidance, which is intended to enable a more flexible approach to assessing the amount of annual provision than was required under the previous statutory requirements. The guidance offers four main options under which MRP could be made, with an overriding recommendation that the Council should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits. The four options are:

    a. The regulatory method – 4% of the borrowing outstanding;
    b. The Capital Financing Method – 4% of the Council’s Capital Financing Requirement;
    c. The Depreciation Method – repayment of the debt over its depreciation life;
    d. The Asset Life Method – repayment over the life of the asset to which the borrowing has been taken to fund.

44. Options a and b have broadly the same impact on the Council, and the DCLG recommends that this method is used in relation to the government supported borrowing. Option c would take the maximum repayment period to 40 years on operational land and buildings. Option d would take the maximum repayment period up to 60 years for some assets. There are merits in adopting all the options, however, in terms of prudence it is recommended that the Council adopts option b for government supported borrowing and option d for unsupported borrowing, with a caveat that the asset life is an absolute maximum and wherever possible the debt should be repaid over a shorter period. To this end it is recommended that the standard repayment period should be up to 25 years or less if the asset life is shorter, unless approval is sought to extended the repayment provision over a longer period and a formal business case is made to the Executive to do so.

45. With all debts, the longer the repayment period the more is paid in interest over the period of the loan. It is therefore deemed as prudent to reduce the period over which the repayments are made.

Corporate Priorities

46. 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

47. 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 C and D respectively.

Recommendations

48. The Executive are asked to recommend that Council approve:
    a. The Prudential Indicators for 2009/10 to 2013/14 (Annex A);
    b. The proposed Treasury Management Strategy for 2009/10
    c. The Specified and Non-specified investments schedule
    d. The revised Treasury Management Policy and Treasury Management Practices (Annexes C and D).

49. **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

Author:
Ross Brown
Corporate Accountant
Corporate Accountancy
Tel No. 551207

Chief Officer Responsible for the report:
Ian Floyd
Director of Resources

Report Approved Ian Floyd Director of Resources	☐	**Date**	23/01/09
Report Approved	Y	**Date**	23/01/09

Specialist Implications Officer(s)

N/a

Wards Affected: **All** Y

For further information please contact the author of the report

Background Papers
2008/09 monitoring working papers and respective EMAP reports.
Prudential Indicator Workings 09/10 – 13/14.
Capital Budget Control 08/09.
Sector Treasury Services Limited Commentary.

Annexes
Annex A – Prudential Indicators 2009/10 – 2013/14
Annex B – Specified and Non-Specified Investments
Annex C – Treasury Management Policy
Annex D – Treasury Management Practices