Executive **16th January 2007**
Report of the Director of Resources

Treasury Management Strategy Statement and Prudential Indicators for 2007/08 to 2010/11

Purpose

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

    - the proposed Prudential Indicators for 2007/08 to 2010/11
    - an integrated Treasury Management Strategy Statement including the annual investment strategy
    - the use of LOBOs for debt restructure purposes

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 four years.

3. The main points for consideration are in relation to the borrowing strategy over the following four years. The Council is embarking on a series of significant capital investments that will realise significant revenue savings over the following 30 years. These investments will see the underlying need to borrow increase from the current trend of between £10-12m a year to a peak of over £30m in 2009/10. The borrowing strategy aims to minimise the risks to the Council of borrowing large amounts in any single year by giving the Council the flexibility to borrow in advance in order to take advantage of favourable interest rates as they arise.

4. The annual investment strategy reviews the projected interest rates over the next 3 years until 2010, and seeks to maximise returns to the Council whilst minimising the risks associated with this.

Background

5. The Local Government Act 2003 requires the Council to ‘have regard to‘ the Prudential Code and to set Prudential Indicators for a minimum of the next three years to ensure that the Council’s capital investment plans are affordable, prudent and sustainable.

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

7. The suggested strategy for 2007/08 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 advisor. The strategy covers:
   - treasury limits in force which will limit the treasury risk and activities of the Council (paragraphs 11 – 13)
   - Prudential Indicators (paragraph 14-15 and Annex A)
   - the current treasury position (paragraph 16-18);
   - prospects for interest rates; (paragraph 19-21)
   - the borrowing requirement and strategy; (paragraph 22-30)
   - debt rescheduling; (paragraph 31-42)
   - the investment strategy; (paragraph 43-48)

Consultation and Options

8. 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 treasury management decisions are delegated to the Head of Finance. To inform sound treasury management operations the Council has contracted Sector Treasury Services as its Treasury Management advisors. 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.

9. The Council approves the Treasury Management Strategy Statement and Corporate Services EMAP is consulted on the Treasury Management Policy and Practices.

10. 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 2007/08 – 2010/11

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".

12. The Council must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax and council rent levels is 'acceptable'. Both the operational limit and authorised limit have risen from £95.6m

and £112.5m respectively in 2005/06 to £144.2m and £165.7m in 2006/07.

13. 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 two successive financial years. As outlined elsewhere on this agenda it is proposed that the Council adopt a 4 year capital programme. This provides the opportunity to set an Authorised Limit in line with the capital programme until 2010/11.

Prudential Indicators

14. The Council is required to set a suite of Prudential Indicators (PI's) to assist it in managing the Treasury Management and Capital expenditure functions. Annex A illustrates the PI's for 2007/08 to 2010/11 with a description of why they are necessary and what they are measuring.

15. The prudential indicators act as a useful tool in advising the treasury management strategy and annual investment strategy, the paragraphs below take account of the other factors that impact on the strategy.

Current Portfolio Position

16. The Council's long term borrowing position at 5th December 2006 is shown in Table 1.

	Principal	**Average Rate %**
PWLB[1]	£93.4m	4.360%
Market[2]	£10.0m	7.155%
TOTAL	**£103.4m**	**4.630%**

Table 1 – Fixed Term Borrowing

17. The Council currently has no variable long term borrowing from the PWLB or other sources.

Investments

18. The Council's total investments at the 5th December 2006 were £56.8m. This comprised money market investments at fixed rates of £31.4m and variable rate investments of £25.4m in three call accounts[3] and the Council's bank account.

Prospects for Interest Rates

[1] The Public Works Loans Board (PWLB) provides local authorities with long term debt and is the main source of local authority borrowing.
[2] This represents one loan that the Council has been unable to exit.
[3] Call accounts are instant access bank accounts that pay preferential rates of interest on deposits.

19. The behaviour of interest rates, both long term and short term have a major influence on the overall treasury management strategy and affects both borrowing and investment decisions. To assist officers in making these important borrowing and investment decisions the Council contracts Sector Treasury Services as its treasury adviser. Part of their service is to assist the Council to formulate a view on interest rates. Annex B draws together a number of current City forecasts for short term or variable (the base rate) and longer term fixed interest rates. The graph below illustrates the projected base rate and PWLB 10 year and 50 year borrowing rate from December 2006 to January 2010.

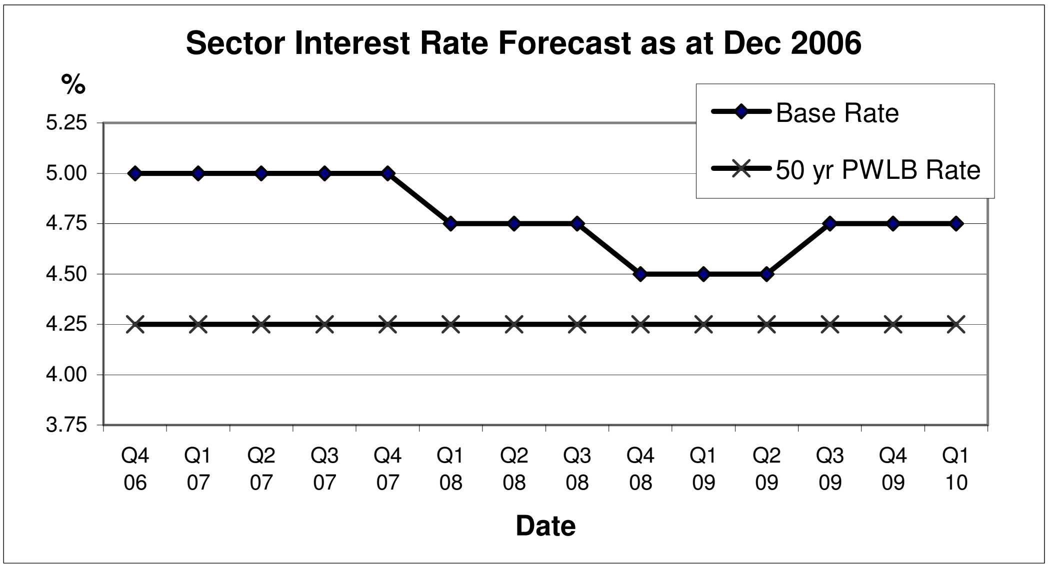


Figure 1 – Sectors Interest rate forecast

Interest rate forecast

20. The base rate is currently at 5% following two 0.25% increases in August and November 2006 from 4.50% after having been at that level for a full year. Forecasts for 2007 to 2009 are now predicting a period of stability until December 2007 where it is expected that rates will need to be reduced by 0.25% in January 2008 before falling again to 4.5% in January 2009. Although it is expected that rates will remain level at 5% for the majority of 2007/08, there is an upside risk early in the first quarter of 2007 (i.e. rates could hit 5.25%).

Economic background

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

UK

a. GDP[4] growth is expected to increase on the back of 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

[4] Gross Domestic Product – A calculation of National Income

is expected in 2007 (2006 2.5%, 2007 2.0%) and to continue at below the trend rate of 2.5% thereafter.

b. Recovery in consumer spending and retail sales has underpinned this upswing in GDP.
c. The housing market has proved more robust than expected; house price inflation over 8% p.a.
d. Higher than expected immigration from Eastern Europe has strengthened growth and dampened wage inflation.
e. MPC[5] decision to raise Bank Rate in November 2006 to bring CPI[6] 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 next pay round.
f. Household income growth to recover in 2007 as inflation falls and pay rises. But extra income likely to go into a recovery of the savings rate, pension saving and servicing debt costs (as rates rise) rather than consumer expenditure.
g. Public sector real increase in expenditure per annum to weaken to 2.5% over the next few years from 3% average over 2000-2005.
h. Increases in Bank Rate in August and November likely to dampen the housing market and also increases in unsecured borrowing.
i. World slowdown in growth in 2007 will dampen UK exports.
j. OUTLOOK: When inflation is back under control, then Bank Rate will switch eventually to a falling trend in 2008 to counter above negative effects on the economy and growth.

International

a. The US, UK and EU economies have all been on the upswing of the economic cycle in 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.
b. The US is ahead of the UK and EU in the business cycle and it looks as if the Fed[7]. rate has probably already peaked at 5.25% whereas there is an expectation in the financial markets of further increases in the EU and UK.
c. 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 (e.g. 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.
d. The Fed. may be reluctant and tardy to respond to the aforementioned downturn in the economy if inflationary pressures

[5] Monetary Policy Committee – the independent body responsible for setting the Bank of England Base Rate
[6] Consumer Price Index – the measure of inflation targeted by the Bank of England
[7] Federal Reserve – the US National Bank responsible for US monetary policy

remain stubbornly high. This could exacerbate the downturn both in the US and the world economies.

e. EU growth picked up strongly in the first half of 2006 and is expected to remain healthy in the second half. Growth to slow moderately in 2007 due to weaker US and global demand.
f. Despite sharply increased energy prices, deflationary 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 around 3% and will fall as the energy effects go into reverse.

Borrowing Strategy

22. Traditionally the Council have been asked to approve a borrowing strategy for the forthcoming financial year. However, last year a medium term borrowing strategy was developed until 2010/11 to take account of the significant levels of capital investment the Council is expecting to make over the next 5 years.

23. Historically the Council has needed to borrow on average between £10m - £12m a year to fund the capital programme. The Government provide grant funding to repay the debt and cover the interest payments. Over the next few years the Council is planning to borrow in addition to the government supported allocations by taking advantage of the prudential borrowing it has been allowed to take since April 2004. The main reason for the projected increase in unsupported borrowing is invest in major projects that will result in long term revenue savings to the Council. The key projects that are likely to be approved by the Council include:

- The Administrative Accommodation Rationalisation Project (£23m)
- The replacement of IT leasing with out right purchase of equipment (£8m over 4 years);
- Investment at the York High School (£1.3m)
- Investment in a new public swimming pool at York High School (£1.2m)

24. As a result of these schemes borrowing is projected to increase from approximately £10m a year in 2006/07 to a maximum of £33m in 2009/10, with the overall level of net debt increasing by £64m by 2010/11.

25. The treasury management and borrowing strategy needs to reflect this position. It would be a risky strategy to borrow in the year when the cash is required for two main reasons:

- A spike in interest rates could leave the Council exposed, especially in 2009/10 when we are expecting to borrow over £30m;

- The government reserve the power to impose a restriction on the amount of prudential borrowing that a Council can take if the macro economic climate dictates.

26. The Sector Treasury interest rate forecast, illustrated in paragraph 17, shows PWLB rates remaining at a central rate of 4.25%. However, they state that we can expect rates to fluctuate by +/- 25 basis points around this level, meaning that we can expect rates to go as low as 4% and as high as 4.5%. Capital Economics have predicted the rate to fall as far as 3.95%.

27. 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 long term borrowing

28. In light of these projections the CYC strategy is therefore as follows:

    - With 50 year PWLB rate at 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 4.10%, significantly below the Council's long term cost of funds of 4.63%.

29. As always, caution will be adopted with the 2007/08 treasury operations. The Head of Finance will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions as part of the monitoring cycle to Corporate Services EMAP.

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

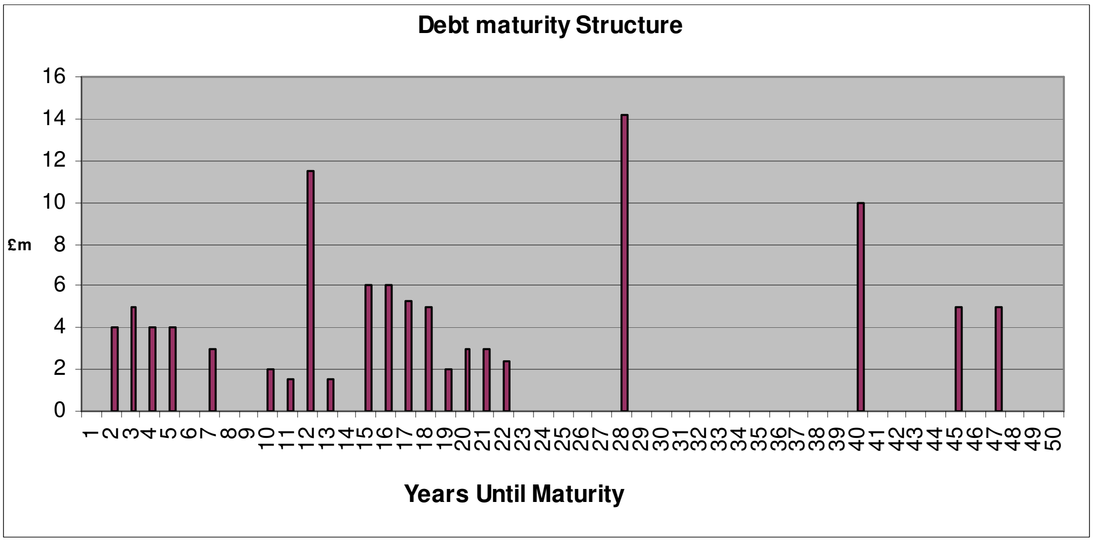
    - *if it were felt that there was a significant risk of a sharp rise in long and short term rates,* perhaps arising from a greater than expected increase in world economic activity or in increases in inflation, then the portfolio position will be re-appraised with the likely action that fixed rate funding 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. There are currently opportunities to restructure shorter term debt into long term debt 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 borrowing strategy outlined above.

32. The Council currently has debts of £103.4m, with an average life of loan of 19 years, the average rate of interest (cost of debt) is 4.63%. All of the Councils debt is at fixed rates of interest. The chart below shows the Councils debt maturity structure.



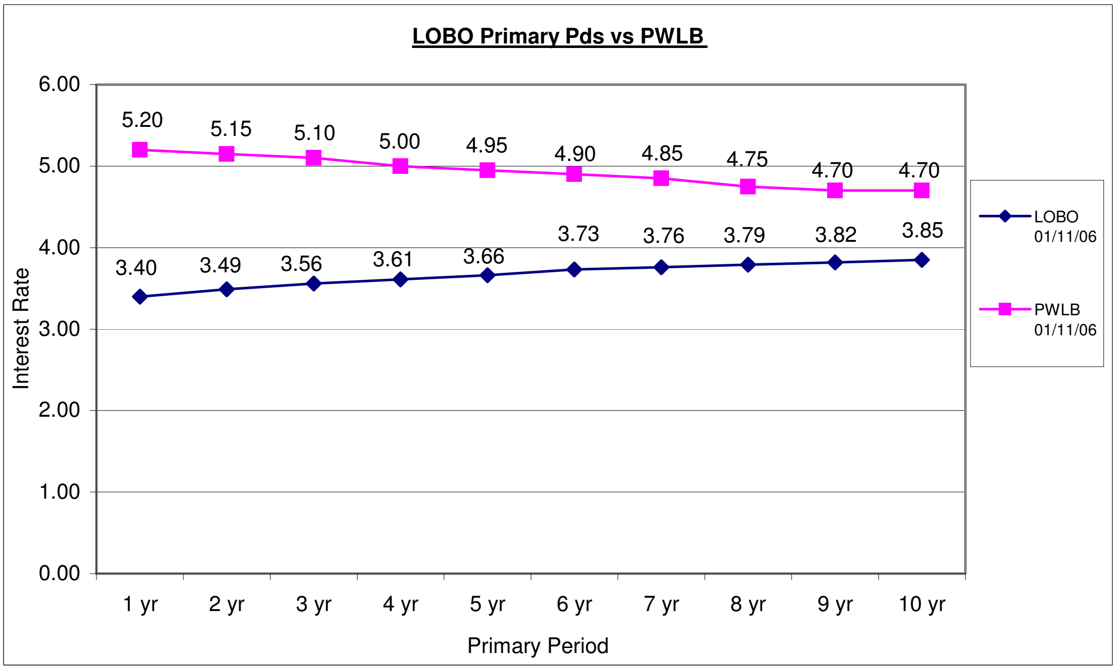
33. The Council can restructure its debt by taking out new loans to replace the existing ones with the aim of reducing the overall cost of debt. Normally during debt restructures the Council switches out of high cost loans into cheaper loans. This switch results in the Council needing to pay a premium which represents the future interest payments that would have been paid over the loan in today's money value, the premium is then written back to revenue over the life of the replacement loan. The opposite would happen if the Council restructured into a higher rate loan, a discount would arise and the discount would be written back to revenue over the life of the replacement loan.

34. The Council can currently restructure its debts by the use of Public Works Loans Boards (PWLB) loans. A potential second option is available to the Council in the form of a financial instrument called Lender Options Borrower Options (LOBO) loans. LOBOs are offered by large financial institutions such as banks where as PWLB loans are offered only by the Treasury.

35. At pre agreed set points the lender has the option to increase the rate the borrower pays on the loan. At this point the borrower then has the option to either accept the increased interest rate which will remain until the next period for change or decline and repay the loan in full. The interest rates offered never go down which means that without tight

controls a borrower could get drawn into holding expensive long-term debt

36. LOBOs offer very cheap primary period rates (the primary period is the first point at which the lender can increase the interest rate) which cannot be matched by either long or short-term PWLB loans. The graph below compares primary period LOBO rates with PWLB rates and shows in the case of LOBOs that the primary period interest rate increases as the fixed primary period increases. There is the potential to make significant savings by restructuring into LOBOs.



37. It is suggested that the Council restructure a limited amount of its current short term maturity PWLB debt into lower rate LOBO debt with matching primary periods.

38. As stated earlier in taking a LOBO there is a danger that by not taking the repayment option the Council could end up with relatively expensive long term debt. As a result the Council should always repay its LOBO loan if the new rate offered by the lender is greater than the in year PWLB trigger rate or if a predetermined limit set at the point when the loan is taken is hit. The in year trigger rate for PWLB borrowing in 2006/07 is 4.00%, therefore the Council would repay the loan if the lender increased the interest rate beyond 4.00% and it is proposed to use the trigger for loans taken in 2006/07 or 2007/08. The 4.00% rate is prudent when compared the Councils Consolidated Rate of Interest (CRI) which is 4.63%. Any loans that are taken at a rate of less than 4.63% would reduce the Councils CRI.

39. 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 reborrowing at lower rates without making significant changes to the type of debt or maturity periods.

40. The reasons for any rescheduling to take place will include:
    - the generation of cash savings at minimum risk;
    - help fulfil the borrowing strategy outlined above; and
    - enhance the maturity balance of the portfolio.

41. The Council will remain cautious in relation to debt restructuring in light of draft changes to the CIPFA accounting standards document (SORP 2007) issued on 18 October 2006 which includes major potential changes in the treatment of the valuation of debt and investments, 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 from 1st April 2007. 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.

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

Investment Policy

43. 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 will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

44. The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

45. Investment instruments identified for use in the financial year are listed in Annex C in the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules, which are updated annually in June.

46. The Council's in-house funds are mainly cashflow derived. Investments will accordingly be made with reference to the core balance, cash flow requirements and the outlook for short-term interest rates. In order to spread risk and actively manage its investments, the Council uses a matrix to set an upper limit on the amount of funds which may be invested with an authorised counterparty.

47. Sector is forecasting the Base Rate to remain at 5.0% from November 2006 until falling to 4.75% in early 2008 and then again to 4.5% by the end of 2008. The Base Rate is then expected to remain unchanged until rising to 4.75% in Q3 2009 and remaining at that level for the foreseeable future. The Council should, therefore, seek to lock in longer period investments at higher rates before this fall starts for the core balances element of the investment portfolio.

48. For its cash flow generated balances, the Council will seek to utilise its business reserve accounts and short-dated deposits (over night to three months) in order to benefit from the compounding of interest.

Corporate Priorities

49. The Treasury Management Strategy Statement and Prudential Indicators are aimed at ensuring the Council *"Improves efficiency and reduces waste to free-up more resources"*

Implications

- **Financial** – Contained within the body of the report
- **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

50. 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 Practices statement which is reviewed annually and approved by Corporate Services EMAP in June of each year.

Recommendations

51. The Executive are asked to recommend that Council approve:
   a) the Prudential Indicators for 2007/08 to 2010/11 (Annex A);
   b) the proposed Treasury Management Strategy for 2007/08 – 2010/11;
   c) the annual investment strategy.
   d) the use of LOBOs for debt management purposes.
   e) the adoption of a predetermined LOBO repayment rate of 4% for LOBOs taken out before 31/03/2008.
   f) the use of PWLB in year borrowing trigger as a trigger to repay LOBO loans.

g) a maximum limit of 10% of total debt portfolio to be funded through LOBO loans at any one time.

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

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Report Approved Y **Date** 5/1/07

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Report Approved Y **Date** 5/1/07

Specialist Implications Officer(s)

N/a

Wards Affected: **All** Y

For further information please contact the author of the report

Background Papers
2006/07 monitoring working papers and respective EMAP reports.
Sector Treasury Services Limited

Annexes
Annex A – Prudential Indicators 2007/08 – 2010/11
Annex B – Interest Rate Projections
Annex C – Specified’ and ‘Non-Specified’ Investments