TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY 2006/07

1 SUMMARY

1.1 This report sets out the Council's treasury strategy for borrowing and investment for 2006/07. In line with the organisational restructuring which will take effect from the replacement of the Corporate Director (Finance and External Services) and the Head of Financial Services, the responsible officer will be the Head of Finance, Audit and Performance Management, once the new officer is in post.

2 INTRODUCTION

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

2.2 The Act therefore requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (included as paragraph 9); this sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

2.3 The suggested strategy for 2006/07 in respect of the following aspects of the treasury management function is based upon the Treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor. The strategy covers:-

- Treasury limits in force which will limit the treasury risk and activities of the Council;
- Prudential Indicators;
- The current treasury position;
- The borrowing requirement
- Prospects for interest rates;
- The borrowing strategy;
- Debt rescheduling;
- The investment strategy;
- Any extraordinary treasury issues (such as the implications of LSVT).

3 TREASURY LIMITS FOR 2006/07 TO 2008/09

3.1 It is a statutory duty under S.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".

3.2 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'.

3.3 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.

4 PRUDENTIAL INDICATORS FOR 2006/07 – 2008/09

4.1 The following prudential indicators (in Table 2 below) are relevant for the purposes of setting an integrated treasury management strategy. The Indicators in Table 1 also appeared in the Budget setting report, with more detailed explanations.

TABLE 1 - BUDGET AND RENT SETTING PRUDENTIAL INDICATORS	2004/05	2005/06	2006/07	2007/08	2008/09
	actual	probable outturn	estimate	estimate	estimate
Capital Expenditure	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Non - HRA	1,884	4,629	1,550	434	379
HRA	1,031	1,824	1,232	1,187	1,200
TOTAL	2,915	6,735	2,477	1,621	1,579
	£	£	£	£	£
Incremental Impact on Council Tax (per Band D) per year	(0.53)	(1.37)	1.41	(0.22)	(0.22)
Incremental Impact on Rents (per property) per year	(4.28)	(3.57)	1.64	0	0
Ratio of financing costs to net revenue stream					
Non - HRA	(6%)	(6%)	(4%)	(4%)	(4%)
HRA	16%	17%	16%	16%	16%
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
Net New borrowing requirement	0	1,955	736	73	0
Capital Financing Requirement as at 31 March	8,453	10,408	11,144	11,217	11,217

TABLE 2. TREASURY MANAGEMENT PRUDENTIAL INDICATORS	2003/04	2004/05	2005/06	2006/07	2007/08
	actual	probable outturn	estimate	estimate	Estimate
	£'000	£'000	£'000	£'000	£'000
Authorised limit for external debt -					
Borrowing (includes overdraft to cover risk of interrupted cashflows)	11,249	16,905	17,910	16.910	16,910
other long term liabilities	126	95	90	90	90
TOTAL	11,375	17,000	18,000	17,000	17,000
Operational boundary for external debt -					
Borrowing	11,216	12,900	13,200	12,900	12,600
other long term liabilities	126	100	100	100	100
TOTAL	11,342	13,000	13,300	13,000	12,700
Upper limit for fixed interest rate exposure					
Net principal re fixed rate borrowing / investments	**11,216**	12,900	13,200	12,900	12,600
Upper limit for variable rate exposure					
Net principal re variable rate borrowing/investments	**17,561**	**20,000**	**20,000**	**20,000**	**20,000**
Upper limit for total principal sums invested for over 364 days	2,000	2,000	2,000	2,000	2,000

Maturity structure of new fixed rate borrowing during 2006/07	upper limit	lower limit
under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

4.2 The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. This was adopted on 19 December 2002 by the full Council.

5 CURRENT PORTFOLIO POSITION

The Council's treasury portfolio position at 31 December 2005 comprised:-

	Balance £m	Average Rate %
Fixed Rate Loans - PWLB Principal	11.04	9.66
Variable Rate Loans	-	-
Investments	14.0	4.92

6 BORROWING REQUIREMENT

	2004/05	2005/06	2006/07	2007/08	2008/09
	£'000 actual	**£'000 probable**	**£'000 estimate**	**£'000 estimate**	**£'000 estimate**
New borrowing	-	1,955	736	73	-
Alternative financing arrangements	-	-	-	-	-
Replacement borrowing	-	-	-	-	--
TOTAL	-	1,955	736	73	-

6.1 The new borrowing for 2006/07 is for the Rayleigh Leisure Centre. Apart from this new borrowing, it is not anticipated that it will be necessary to undertake any other borrowing in 2006/07 to finance the capital programme, although temporary short-term borrowing may have to be undertaken for cash flow purposes.

6.2 Prospects For Interest Rates

6.3 The Council has appointed Sector Treasury Services as treasury adviser to the Council. Using a variety of forecasts published by a number of institutions, including HM Treasury, Sector assist the Council to formulate a view on interest rates. The following table gives the Sector view:

	Q/E4 2005	Q/E1 2006	Q/E2 2006	Q/E3 2006	Q/E4 2006	Q/E1 2007	Q/E2 2007	Q/E3 2007	Q/E4 2007
Base Rate	4.50%	4.50%	4.25%	4.25%	4.00%	4.25%	4.50%	4.75%	4.75%
5yr Gilt Yield	4.25%	4.00%	4.00%	4.25%	4.50%	4.75%	4.75%	4.75%	4.75%
10yr PWLB Rate	4.50%	4.25%	4.50%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%
25yr PWLB Rate	4.50%	4.50%	4.50%	4.50%	4.75%	4.75%	4.75%	5.00%	5.00%

6.4 Sector's current interest rate view is that the base rate will:-

- remain on hold at 4.5% until the end of Q1 2006
- fall to 4% by the end of Q4 2006
- edge up by 0.25% in Q1, Q2 and Q3 of 2007 to end the year at 4.75%

6.5 The risk to this forecast is to the downside in as much as the cuts in rates could occur earlier than our forecast suggests, although this will not necessarily affect the timing of the first upward move in Q1 2007.

6.6 Borrowing Strategy

6.7 The Sector forecast is as follows:-

- The new 50 year PWLB rate will remain flat at 4% until Q4 2006 when it will rise to 4.25% with a further increase to 4.5% in Q2 2007.
- 25-30 year PWLB rate will remain flat at 4.5% until Q3 2006 when it will rise to 4.75% with a further increase to 5.00% in Q4 2007
- 10 year PWLB rate to dip to 4.25% in the first quarter of 2006 but will then rise to reach 4.75% in Q3 2006 and then remain unchanged until the end of 2007.
- 5 year gilt yields will follow base rate down and trough by the end of Q1 2006 at 4.00%. Yields will then rise to 4.25% in Q3, 4.5% in Q4 2006 and to 4.75% in Q1 2007 as the interest rate cycle turns up again.

6.8 This forecast indicates, therefore, that the borrowing strategy for 2006/07 should be set to consider taking long dated borrowings in the first half of the fiscal year before PWLB rates rise. Variable rate borrowing and borrowing in the five year area is also expected to be attractive in the first half of the fiscal year while the base rate is on a falling trend.

6.9 The Head of Finance, Audit and Performance Management will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to Council at the next available opportunity.

6.10 Debt Rescheduling

6.11 Opportunities may exist for restructuring long term debt into short term variable rate debt to produce savings later in the year, particularly once base rate has fallen to 4.25%. With variable rate borrowing rates likely to fall significantly during 2006/07, it will be best to avoid restructuring into fixed borrowing for short periods (e.g. one year). Long term fixed rates are not expected to rise back above 4.75% during 2006/07. Consequently long term debt rates at or around 4.75% would warrant reviewing the potential for undertaking debt restructuring. Any positions taken via rescheduling will be in accordance with the strategy position outlined in paragraph 6.8 above.

6.12 In addition, the Council will 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 (fixed/variable) or maturity periods. This consideration will include the effect on the General Fund of any housing subsidy implications on debt rescheduling.

6.13 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 7 above; and
- In order to enhance the balance of the long term portfolio

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

7 ANNUAL INVESTMENT STRATEGY

Investment Policy

7.1 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:-

(a) the security of capital and

(b) the liquidity of its investments.

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

7.3 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.

7.4 Investment instruments identified for use in the financial year are listed below under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

7.5 **<u>Specified Investments</u>**:

Investment instruments identified for use in-house in the financial year remain the same as those agreed last year, and are listed below. The Council does not use a fund manager.

Debt Management Agency Deposit Facility (Government Managed)	See below for counterparty limits
Term deposits – UK government	
Term deposits – other Local Authorities	
Term deposits – banks and building societies	
Money Market Funds	

7.6 The Council uses Fitch ratings to derive its counterparty criteria. Where a counterparty does not have a Fitch rating, the equivalent Moody's rating will be used. All credit ratings are monitored monthly and the Council is alerted to changes in Fitch ratings through its use of the Sector creditworthiness service. If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

7.7 The authority to make changes to the counterparty list in line with the criteria below was delegated to the Corporate Director (Finance & External Services) when the strategy for 2005/06 was agreed on 27 January 2005. This authority will need to be given to the new post of Head of Finance, Audit and Performance Management, once that person is in place.

7.8 The approved Counterparty list is determined by the following minimum criteria:

ORGANISATION	**CRITERIA**	**MAX AMOUNT**	**MAX PERIOD**
U.K. Clearing Bank & U.K. Building Society	Minimum F1+ short term backed up by AA long-term credit rating and support rating of 1 or 2	£2M	3 years
U.K. Clearing Bank & U.K. Building Society	Minimum F1 or P1 short term backed up by AAA or AA- long-term credit rating, individual rating B and support ratings of 1, 2 or 3.	£6m	364 days
U.K. Clearing Bank & U.K. Building Society	Minimum F1 or P1 short term backed up by A long-term credit rating, individual rating B and support ratings of 1, 2 or 3.	£3m	3 months
UK Local Authorities		£6m	364 Days
Other UK Financial Institutions & Government Bodies	Minimum F1+ short term backed up by AA+ long-term credit rating and support rating of 1	£6m	364 days
Money Market Funds	Minimum AAA long-term credit rating	£6m	364 days

Investment Strategy

7.9 The Council does not use a fund manager and the funds managed in-house are a split between those cash-flow derived and core balances. Investments will accordingly be made with reference to the core balances and cash flow requirements and the outlook for short-term interest rates (ie rates for investments up to 12 months).

7.10 Sector is forecasting base rates to be on a falling trend from 4.50% to reach 4.00% in Q4 2006 but to rise again to end Q1 2007 at 4.25%. The Council will therefore seek to lock in longer period investments at higher rates before this fall starts for some element of their investment portfolio which represents their core balances. Some investments will be aimed to mature during Q1 2007 when the interest rate cycle turns up. This should enable the Council to lock into higher yielding investments with their maturing deposits.

7.11 The Council has identified 4.8% as an attractive trigger rate for 1-year lending and 5.5% for up to *2-3* year lending. The 'trigger points' will be kept under review and discussed with Sector so that investments can be made at the appropriate time.

7.12 For its cash flow generated balances, the Council will seek to utilise its business reserve accounts and short-dated deposits (1-3 months) in order to benefit from the compounding of interest.

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

8 LARGE SCALE VOLUNTARY TRANSFER (LSVT)

8.1 The proposed future LSVT raises a number of complex and critical decisions which will need to be considered and planned for in advance of the physical cash transaction taking place. These will include:

- What will be the policy with the LSVT proceeds - repay debt or retain the investments?

- What is the likelihood of the transfer taking place?

8.2 The impact of the LSVT on both drawing capital finance and the repayment of debt, assuming debt will be repaid on transfer, suggests:

- Capital finance may be delayed in order to avoid potentially expensive penalties;

- Rescheduling in advance of the LSVT transaction may allow the Authority to minimise penalties, maximise discounts and take advantage of the housing subsidy regulations.

8.3 The new Head of Finance, Audit and Performance Management, in consultation with Sector and the financial consultants appointed to support the stock option process, will need to keep the situation under review

9 RISK IMPLICATIONS

9.1 It is necessary to outline the risks involved in the investments made by the Council. There is of course always a risk that a building society or bank may fail during the duration of an investment but this is not considered likely where the institution has a minimum credit rating as specified in our Investment Strategy. With regard to deposits for more than one year, the advantage from a treasury management point of view is that there is a known rate of return over the period that the monies are invested which aids forward planning. There is however the increased risk due to the longer time span that a) the institution fails or b) interest rates rise in the meantime. Therefore no investments for more than 1 year will be made without the advice of our Treasury Consultants on the likely movement of interest rates over the period of the proposed investment. The Council may use Money Market Funds from AAA-rated institutions for cash balances. These are funds with the highest credit rating, providing excellent security for the council's money. Surplus balances not invested in pure cash deposits can earn a rate similar to 1 month LIBID, and funds can be accessed with minimal notice. Returns are not fixed, however, and will rise and fall in line with the market. As a result, these funds will not be used to take a view on the likely future path of interest rates, or as a protection against falling rates. Their natural use is for balances too small to place with banks and building societies, or as an alternative to a bank call account. No investments will be made in Money Market Funds without the advice of our Treasury Consultants.

9.2 Resource Risk

Investment income is a material source of income to the Authority. The amount of income generated is dependent upon interest rates and there is always a risk of falling rates

9.3 Strategic Risk

The results of the Housing Stock Option Appraisal will raise a number of critical decisions which will impact on the Investment Strategy and need to be considered and planned for in advance of any physical cash transaction taking place.

9.4 **Interest Risk**

The main sensitivities of the interest rate forecasts are likely to be the two scenarios below. The Council 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 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, 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 remaining low or weakening, then long term borrowings will be postponed, and any rescheduling from fixed rate funding into variable or short rate funding will be exercised.

9.5 **Operational Risk**

The treasury management function cannot take place without an agreed Treasury Management Strategy in place before the start of the financial year.

9.6 **Reputation Risk**

The Authority is responsible for managing the investment of public funds and must be seen to be adopting a pragmatic and prudent approach.

9.7 **Regulatory Risk**

The treasury management function cannot take place without an agreed Treasury Management Strategy in place before the start of the financial year.

10 **RESOURCE IMPLICATIONS**

All interest paid and received is accounted for within the General Fund. Charges to the Housing Revenue Account are made in accordance with Government Regulations.

11 **RECOMMENDATION**

11.1 It is proposed that the Council **RESOLVES**

(1) To agree the Treasury Management Strategy Statement and Annual Investment Strategy including the limits contained within the report

(2) To agree that the new Head of Finance, Audit and Performance Management, once appointed and operational can undertake the prudential borrowing outlined in this report

(3) To agree the Authorised Limit and Operational Boundary for external debt as laid down in the report and delegate authority to the Head of Finance, Audit and Performance Management, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long term liabilities, once that person is in place.

(4) To delegate to the Head of Finance, Audit and Performance Management, the authority to add and remove counterparties in line with the criteria agreed by Council on 27 January 2005, once that person is in place.

Dave Deeks

Head of Financial Services

Background Papers:-

CIPFA Prudential Code
CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes
Local Government Act 2003
ODPM's Guidance on Local Government Investments March 2004

For further information please contact Mrs Yvonne Woodward on:-

Tel:- 01702 546366
E-Mail:- yvonne.woodward@rochford.gov.uk