TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY 2007/08

1 SUMMARY

1.1 This report sets out the Council's treasury strategy for borrowing and investment for 2007/08.

2 INTRODUCTION

2.1 The Local Government Act 2003 and supporting regulations 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 (as required by Investment Guidance issued subsequent to the Act) (included as paragraph 7); 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 2007/08 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).

2.4 It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore, means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from:-

- Increases in interest charges caused by increases borrowing to finance additional capital expenditure, and

- Any increases in running costs from new capital projects, are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

3 TREASURY LIMITS FOR 2007/08 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". In England and Wales the Authorised Limit represents the legislative limit specified in section 3 of the Local Government Act 2003.

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 2007/08 – 2008/09

4.1 The following prudential indicators (in Table 2 - See Page 5.4) are relevant for the purposes of setting an integrated treasury management strategy. The Indicators in Table 1 (See Page 5.3) also appeared in the Budget setting report, with more detailed explanations.

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

TABLE 1 - BUDGET AND RENT SETTING PRUDENTIAL INDICATORS	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**
	Actual	**Probable outturn**	**Estimate**	**Estimate**	**Estimate**
Capital Expenditure	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Non - HRA	**4,534**	**1,594**	**570**	**419**	545
HRA	**1,429**	**1,246**	**1,187**	**-**	-
TOTAL					
	5,963	2,840	1,757	419	545
	£	£	£	£	£
Incremental Impact on Council Tax (per Band D) per year	0.03	0.07	0.21	0.06	0.31
Incremental Impact on Rents (per property) per year	0.00	0.55	0.00	0.00	0.00
Ratio of financing costs to net revenue stream					
Non - HRA	(6%)	(6%)	(4%)	(4%)	(4%)
HRA	15%	16%	15%	0%	0%
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
Net New borrowing requirement	**0**	**473**	**73**	**0**	**0**
Capital Financing Requirement as at 31 March	**10,396**	**10,700**	**11,000**	**10,100**	**9,200**

TABLE 2 - TREASURY MANAGEMENT PRUDENTIAL INDICATORS	2005/06	2006/07	2007/08	2008/09	2009/10
	Actual	Probable outturn	Estimate	Estimate	Estimate
Authorised limit for external debt -	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Borrowing (includes overdraft to cover risk of interrupted cashflows)	11,249	17,000	16,900	16,700	16,600
Other long term liabilities	88	81	80	80	80
TOTAL	11,337	17,081	16,980	16,780	16,680
Operational boundary for external debt					
Borrowing	11,216	13,200	13,000	12,600	12,300
Other long term liabilities	88	81	80	80	80
TOTAL	11,304	13,281	13,080	12,680	12,380
Upper limit for fixed interest rate exposure					
Net principal re fixed rate borrowing / investments	11,216	13,200	12,900	12,600	12,200
Upper limit for variable rate exposure					
Net principal re variable rate borrowing/investments	16,124	13,741	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 2007/08	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%

5 CURRENT PORTFOLIO POSITION

5.1 The Council's treasury portfolio position at 31 December 2006 comprised:-

	Balance £M	Average Rate %
Fixed Rate Loans - PWLB Principal	10.324	9.9
Variable Rate Loans	-	-
Investments	11.041	5.18

6 BORROWING REQUIREMENT

	2005/06	2006/07	2007/08	2008/09	2009/10
	£'000 Actual	£'000 Probable	£'000 Estimate	£'000 Estimate	£'000 Estimate
New borrowing	1,868	473	73	-	-
Alternative financing arrangements	-	-	-	-	-
Replacement borrowing	-	-	-	-	-
TOTAL	-	473	73	-	-

6.1 The new borrowing for 2007/08 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 2007/08 to finance the capital programme, although temporary short-term borrowing may have to be undertaken for cash flow purposes.

Prospects For Interest Rates

6.2 The Council has appointed Sector Treasury Services as treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. The following table gives the Sector central view:-

	2007				2008				2009				2010	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Base Rate (%)	5.50	5.50	5.50	5.25	5.00	4.75	4.75	4.75	4.75	5.00	5.00	5.00	5.00	5.00
5yr Gilt Yield (%)	5.25	5.25	5.00	4.75	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
10yr PWLB Rate (%)	5.00	5.00	4.75	4.75	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
25yr PWLB Rate (%)	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
50yr PWLB rate (%)	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25

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

- Peak at 5.50% in quarter 1 2007
- fall to 5.25% in Q4 2007 and then to 5.00% in Q1 2008

- fall to 4.75% in Q2 2008 before rising back to 5.00% in Q2 2009.

Borrowing Strategy

6.6 The Sector forecast is as follows:-

- The 50 year PWLB rate is expected to remain flat at 4.25%. As the Sector forecast is in 25bp segments there is obviously scope for the rate to move around the central forecast by +/-25bp without affecting this overall forecast.
- The 25-30 year PWLB rate is expected to stay at 4.50% for the foreseeable future.
- The 10 year PWLB rate will fall from 5.00% to 4.75% in Q3 2007 and then fall again to 4.5% in Q1 2008 and remain at that rate for the foreseeable future.
- 5 year PWLB rate will fall from 5.25% to 5.0% in Q3 2007 and continue falling until reaching 4.5% in Q1 2008 when it will remain at that rate for the foreseeable future.

6.7 This forecast indicates, therefore, that the borrowing strategy for 2007/08 should be set to take very long dated borrowings at any time in the financial year. 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 taking long-term borrowing.

6.8 For authorities wishing to minimise their debt interest costs, the main 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 1- year area. A suitable trigger point for considering new fixed rate long term borrowing, therefore, would be 4.25%.

6.9 Against this background caution will be adopted with the 2007/08 treasury operations. 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.

Debt Rescheduling

6.10 As the first fall in Bank Rate is expected in Q4 2007, there will be a sharp difference between higher short-term rates and cheaper long-term rates in quarters 2 to 4 of 2007. Later on in 2007/08, this advantage will diminish once Bank Rate, and short-term rates generally, start falling. There will therefore be opportunity during quarters 2 to 4 of 2007 to restructure shorter-term debt into long term 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 strategy position outlined in paragraph 6.8 above.

6.11 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 (fixed/variable) or maturity periods.

6.12 The reasons for any rescheduling to take place will include:-

- the generation of cash savings at minimum risk;
- Help fulfill the strategy outlined in paragraph 6.8 above; and
- Enhance the balance of the long-term portfolio (amend the maturity profile and/or the balance of volatility).

6.13 CIPFA issued a draft accounting standards document (SORP 2007) 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 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.

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 Central Governments 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.

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.

Specified Investments:

7.5 Investment instruments identified for use in-house in the financial year remain the same as those agreed last year, and are listed below.

Debt Management Agency Deposit Facility (Government Managed)	See below for organisation 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 organisation 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 organisation/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

7.7 The approved Organisation 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
U.K. Local Authorities		£6M	364 Days
Other U.K. 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

7.8 The Council does not use a fund manager and the funds managed in-house are a split between those cashflow 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 (i.e. rates for investments up to 12 months).

7.9 Sector is forecasting Bank Rate to peak at 5.5% in Q1 2007 before falling to 5.25% in Q4 2007, to 5.00% in Q1 2008, and then to trough at 4.75% in Q2 2008, remaining at that level before rising again to 5.00% in Q2 2009. Councils should, therefore, seek to lock in longer period investments at higher rates before this fall starts for some element of their investment portfolio, which represent their core balances. For 2007/08 clients should budget for an investment return of 5.00%.

7.10 The Council has identified 5.6% as an attractive trigger rate for 1-3 year lending and 5.50% for 4-5 year lending. The 'trigger points' will be kept under review and discussed with Sector so that investments can be made at the appropriate time.

7.11 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.

7.12 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 Proceeds from the transfer of the Council's Housing stock will either be used to repay debt or retain the investments, this will need to be decided before the physical cash transaction occurs.

8.2 The impact of the transfer 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 transfer transaction may allow the Authority to minimise penalties, maximise discounts and take advantage of the housing subsidy regulations.

8.3 The 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.

9.2 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.

9.3 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 London Interbank Bid Rate, 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.

Resource Risk

9.4 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.

Strategic Risk

9.5 The transfer of the Council's Housing Stock will impact on the Investment Strategy and need to be considered and planned for in advance of any physical cash transaction taking place.

Interest Risk

9.6 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.

Operational Risk

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

Reputation Risk

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

Regulatory Risk

9.9 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

10.1 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 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.

Yvonne Woodward

Head of Finance, Audit and Performance Management

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 Miss Carrie Watkins on:-

Tel:- 01702 546366
E-Mail:- carrie.watkins@rochford.gov.uk