TORBAY COUNCIL

Report No: F/20/04

Title: **2004/05 Treasury Management Strategy**

To:	Executive	on	16th February 2004
	Council	on	4th March 2004

1. Purpose

1.1 This report summarises the strategy and key issues likely to impact the treasury management function in 2004/05.

2. Relationship to Corporate Priorities

2.1 All Themes

3. Recommendation

3.1 That the Treasury Management Strategy for 2004/05 be approved.

3.2 That, in line with the Council's Constitution and Financial Regulations:

(i) the Director of Finance be authorised to take executive decisions on borrowing and investments. (Delegations to Director of Finance, paragraph 5.1(a))

(ii) the Director of Finance be authorised to invest temporarily or utilise surplus monies of the Council. (Financial Regulations, paragraph 15.3)

3.3 That the Schedules to the adopted Treasury Management Practices be incorporated into the Treasury Management Policy and the Director of Finance be authorised to review and amend these schedules as necessary.

4. Reason for Recommendation

4.1 The formulation of a Treasury Management Strategy is a requirement of the CIPFA Code of Practice in Treasury Management and the Council's Treasury Management Policy.

5. Background

5.1 The Council defines its treasury management activities as:

"The management of the authority's cash flows, it's banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".

5.2 The Council has customarily considered an annual Treasury Strategy Statement under the requirement of the CIPFA Code of Practice on Treasury Management, which was adopted by the Council on 19th February 2002. The new Prudential Code for Capital finance has introduced new reporting and monitoring requirements with regard to the development of capital spending plans. A separate report detailing these requirements was presented to the

Executive in November 2003. The actual Prudential Indicators which have to be set under the Code will be presented to Council before the end of march and this treasury management strategy should be read in conjunction with that report.

5.3 The Prudential Code requires the Council to set a number of Prudential Indicators, certain of which replace the borrowing/variable interest limits previously determined as part of the strategy statement, whilst also extending the period covered from one to three years. This report therefore incorporates the indicators to which regard should be given when determining the Council's treasury management strategy for the next 3 financial years.

5.4 The suggested strategy for 2004/05 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;
- the current treasury position;
- borrowing requirement;
- prospects for interest rates;
- the borrowing strategy;
- the investment strategy;
- the extent of debt rescheduling opportunities;
- temporary borrowing requirements;
- reporting arrangements and management evaluation;
- any other treasury matters.

5.5 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 capital expenditure must be limited to a level whereby increases in charges to revenue from:-

i. increases in interest incurred by increased borrowing to finance additional capital expenditure,
ii. interest lost by spending of reserves used to finance additional capital expenditure, and
iii. 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.

5.6 The provisional 2004/05 budget therefore has been set at a level which will cover the Council's borrowing requirements based on Supported Borrowing and the Capital Budget and debt re-financing requirements.

5.7 The interest receipts budget, which is directly linked to the Council's borrowing position, is based on an average investment balance of £22 million, which includes monies held by the Council's external Funds Manager. Paragraph 9.1 deals with interest rate assumptions incorporated into the budget.

5.8 It is anticipated that the Council's core cash balance available for investment would, on average, be equal to:

(i) the Council's cash-backed longer-term reserves (such as the Insurance Reserve and General Fund balance) along with the "day to day" net movement between receipts and payments which are estimated to average £12 million over the year, plus

(ii) the Fund Manager holding of £10million which effectively reflects reserved (unusable) capital receipts.

5.9 Treasury Management staff will review the core cash position in light of any movement in the Councils' finances including the requirement to make an annual Minimum Revenue Provision toward the repayment of debt.

6. Treasury Limits for 2004/05 to 2006/07

6.1 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".

6.2 The Council must have regard to the Prudential Code when setting its Affordable Borrowing 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 levels is 'acceptable'.

6.3 Whilst termed an "Affordable Borrowing Limit", the capital plans to be considered for inclusion incorporate those planned to be financed by both external borrowing and other forms of credit arrangement. The affordable borrowing limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years. The draft Affordable Borrowing Limit is laid out, together with other indicators, in the report on the Capital Budget elsewhere on this agenda.

6.4 The following table sets out the draft prudential indicators relevant for the purpose of setting an integrated treasury management strategy.

No.	PRUDENTIAL INDICATOR	2003/04	2004/05	2006/07	2007/08
14	**Upper limit for fixed interest rate exposure**				
	Net principal re fixed rate borrowing/investments	100%	100%	100%	100%
15	**Upper limit for fixed interest rate exposure**				
	Net principal re variable rate borrowing/investments	60%	60%	60%	60%
17	**Upper limit for total principal sums invested for over 364 days** (per maturity)	£11M	£11.5M	£12M	£12.5M
16	**Maturity structure of new fixed rate borrowing during 2004/05**	**upper limit**		**lower limit**	
	under 12 months	65%		0%	
	12 months and within 24 months	70%		0%	
	24 months and within 5 years	35%		0%	
	5 years and within 10 years	35%		0%	
	10 years and above	100%		30%	

6.5 These indicators along with the other Prudential Indicators required under the code will be finalised for presentation to Council before the end of March 2004.

7. Current Portfolio Position

7.1 The Council's treasury portfolio position at 30th January 2004 comprised:

BORROWING		**Principal**	**Average Rate**
Fixed Rate Funding	PWLB	£31.178m	4.6923%
Variable Rate Funding	PWLB	£ 1.461m	4.1250%
	Market	£ 0.208m	4.8275%
Total Debt		**£32.847m**	**4.6679%**
INVESTMENTS			
Investments Managed In House – Average for year		£ 8.387m	3.6022%
Fund Manager - Average for year		£10.000m	3.6666%
Total Investments		**£18.179m**	**3.6382%**

7.2 Further borrowing will be taken before 31st March 2004. In conjunction with the Councils' treasury advisors the Director of Finance has elected to borrow the majority of the years requirements at variable rates. As variable rates are forecast to remain stable the point of borrowing is being delayed in order for the Council to benefit from reduced interest payments from the current year budget.

8. Borrowing Requirement

8.1 The table below illustrates the possible borrowing profile over the next few years.

	2003/04	2004/05	2005/06	2006/07
	£000	**£000**	**£000**	**£000**
New borrowing	9,660	8,973	7,528	4,040
Alternative financing arrangements *	650	1,800	764	1,134
Replacement borrowing	5,846	8,461	10,500	5,961
TOTAL	**16,156**	**19,234**	**18,792**	**11,135**

* Covers the potential replacement of Fleet vehicles through other sources of financing such as finance leases and operating leases.

9. Prospects for Interest Rates

9.1 The Council appointed Sector Treasury Services as a treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. Appendix 1 draws together a number of current City forecasts for short term or variable (the base rate or repo rate) and longer fixed interest rates. The following table gives the Sector central view:

Sector View interest rate forecast – December 2003

(%)	Q4 2003	Q1 2004	Q2 2004	Q3 2004	Q4 2004	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006
Base Rate	3.75%	4.00%	4.00%	4.25%	4.25%	4.50%	4.50%	4.50%	4.50%	4.50%
5yr Gilt Yield	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%
10yr PWLB	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
25yr PWLB	5.00%	4.75%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%

9.2 There is also an upside risk that base rate might rise more quickly in 2004 if world economic recovery is stronger and faster than forecast. In addition, there is a risk that PWLB rates between 10 and 25 years could fall by up to 0.50% below the above forecasts for limited periods if there were exceptional selling pressure on equities.

9.3 Appendix 2 provides a commentary of the economic factors affecting UK interest rates. A more detailed analysis is available on request.

10. <u>Borrowing Strategy</u>

10.1 Based upon the prospects for interest rates outlined above, there are a number of strategy options available. The expectation is that short-term variable PWLB rates will continue to be cheaper than long-term PWLB fixed rate borrowing during 2004/05. Short term variable rates are expected to rise in line with increases in base rate. Long term rates are not currently expected to move far but if there were a major fall in share prices (which is not expected given the general expectations for world economic recovery), then long rates would be susceptible to a corresponding fall. These expectations provide a variety of options:

- that short term variable rates will be good value compared to long term rates, and are likely to remain so for potentially at least the next couple of years. Best value will therefore be achieved by borrowing short term at variable rates in order to minimise borrowing costs in the short term or to make short term savings required in order to meet budgetary constraints
- that the risks intrinsic in the shorter term variable rates are such, when compared to historically relatively low long term fixed funding, which may be achievable in 2004/05, that the Council will maintain a stable, longer term portfolio by drawing longer term fixed rate funding at a marginally higher rate than short term rates.

10.2 Against this background caution will be adopted with the 2004/05 treasury operations. At the time of this report the advice of the Council's treasury advisors is to borrow short term at variable rates. If fixed PWLB rates should fall significantly, they view a suitable trigger point for considering new fixed rate long term borrowing would be about 4.5%. The Director of Finance will monitor the interest rate market and adopt a pragmatic approach to any changing circumstances, reporting any significant decisions to the Executive Member for Finance at the earliest opportunity.

10.3 **Sensitivity of the forecast -** The main sensitivities of the forecast 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 was 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 was 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.

10.4 At this stage it is anticipated that the Council will need to borrow to fund its approved Capital Plan Budget in future years. The table below shows an indication of the possible level of borrowing required for the next three years based on the Council's Capital Plan proposals to be considered by the Executive on 16th February 2004.

Year	Supported Borrowing £million	Unsupported Borrowing £million	Total Borrowing £million
2004/05	10	0	10
2005/06	7	0	7
2006/07	4	0	4

In addition, any maturing debt will be refinanced by new borrowing. At this stage it is anticipated that £8.5 million of existing debt will mature in 2004/05 (see paragraph 8.1).

10.5 Actual borrowing will depend on timing of capital expenditure, use of capital receipts and prevailing interest rates.

10.6 Periods of borrowing will be managed to achieve, as far as possible, an even maturity profile over the long term. The debt maturity profile for current loans is included at Appendix 3.

10.7 The Council's source of borrowing has, to date, been restricted to the Public Works Loan Board (PWLB). Other sources are currently being evaluated including the potential use of LOBOs (Lender Option/Borrower Option). The Director of Finance will use these instruments if they offer better value than PWLB arrangements.

11. Investments Strategy

11.1 The money market yield curve is currently anticipating a rising base rate for the next year (see paragraph 9.1).

11.2 The in-house treasury management team maintains only temporary, short-term investments and investments will accordingly be made with reference to cash flow requirements as well as maximising interest returns.

11.3 The performance target for the in-house team is to achieve an overall investment return equal to or better than the 7-day LIBID market rate.

11.4 The Director of Finance, in conjunction with the Council's Treasury Advisors, has formulated criteria based on counterparty creditworthiness against which current and prospective borrowers are to be judged. A review of the criteria has indicated advantages in streamlining the limits currently applied.

11.5 Appendix 4 provides the current counterparty list with the revised period and specific financial ceilings based on the adopted criteria. The new limits will allow the Council enough flexibility to operate effectively within the financial markets while maintaining an appropriately low exposure to risk.

11.6 Investments are currently governed by the Approved Investments Regulations (1990) and subsequent amendments. The government is consulting on new arrangements planned for 1st April 2004. A new requirement will be for the Council to formulate and approve an Annual Investment Strategy. This will be prepared once the consultation process has been completed.

11.7 In November 2001, Alliance Capital Fund Managers were appointed to manage £10 million of the funds arising from the sale of the Council's housing stock. Their current strategy is to invest short until either bond yield rise way above cash rates or the end of interest rate hikes seems to be near.

11.8 The mandate with Alliance Capital allows for additional amounts to be placed with the Fund Manager and the Director of Finance will exercise this option if this is deemed to be in the best interests of the Council.

11.9 The performance target for the Fund Manager is to achieve a return of 10% in excess of the 7-Day LIBID market rate, net of fees over a three year period.

12. Temporary Borrowing Requirements

12.1 The Council may have to borrow temporary funds to cover short-term cash flow requirements. In this event the Council will either,

i) utilise the pre-arranged overdraft facility with the Council's bankers (up to £1,000,000), or
ii) borrow through the approved brokers from institutions listed by the Financial Services Agency

13. Debt Rescheduling

13.1 With variable rate borrowing and fixed borrowing for short periods (e.g. one year) at rates below 4.5%, opportunities may exist for restructuring long term debt into short term debt to produce savings. Fixed rates are not expected to rise back up to about 5.25% to 5.5% during 2004/05. Consequently long term debt rates at or above 4.90% would warrant reviewing the potential for undertaking debt restructuring. Any positions taken via rescheduling will be in accordance with the strategy position outlined in section 10 above.

13.2 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 section 10 above; and
- In order to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of exposure to variable rates).

13.3 All rescheduling will be reported to the Executive, at the meeting following its action.

14. Reporting Arrangements and Management Evaluation

14.1 The Director of Finance will inform the Executive Member for Finance of any long-term borrowing undertaken or any significant events that may affect the Council's treasury management activities. The Director of Finance will maintain a list of staff authorised to undertake treasury management transactions on behalf of the Council.

14.2 The Director of Finance is authorised to approve any movement between the Prudential Indicator for borrowing and other long term liabilities provided that the Authorised Limit and Operational Boundary remains unchanged. Any such change will be reported to the next meeting of the Council.

14.2 The impact of these policies will be reflected as part of the Council's revenue account and therefore there will be reporting through the quarterly budget monitoring process.

14.3 The Council's management and evaluation arrangements for Treasury management are as follows:

- Weekly monitoring report
- Monthly meeting of the Treasury Manager/Chief Accountant/Assistant Director of Corporate Finance to review previous months performance and plan following months activities
- Regular meetings with the Council's treasury advisors
- Regular meetings with the Council's appointed Fund Managers
- Membership and participation in the CIPFA Benchmarking Club

15. Other Matters

15.1 The Council's adopted policy on Treasury Management details the specific Treasury Management Practices in accordance with the CIPFA Code of Practice.

15.2 To further comply with the CIPFA Code the Director of Finance has drawn up schedules to formally outline how the approved Treasury Management Practices will be put into effect.

15.3 The schedules are reproduced at Appendix 5 for incorporation into the adopted Treasury Management Policy.

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IMPLICATIONS, CONSULTATION AND OTHER INFORMATION

Part 1

These sections may be completed by the Report author but must be agreed by named officers in the Legal, Finance, Human Resources and Property Divisions. If these are not completed and agreed the Report will not be included on the agenda.

Does the proposal have implications for the following issues?

		Insert name of responsible officer
Legal (including Human Rights)	As specified in the body of the report.	Lorna Lee
Financial – Revenue	As specified in the body of the report.	Martin Phillips
Financial – Capital Plan	As specified in the body of the report	Lynette Royce
Human resources (including equal opportunities)	No	
Property	No	

Part 2

These sections must be completed by the author of the Report.

Does the proposal have implications for the following issues?		Please give details as appropriate
Sustainability	Yes or No	Yes
Crime and Disorder	Yes or No	No
*OfSTED Post Inspection Action Plan	Yes or No	No
*Social Services Action Plan	Yes or No	No
*Change Management Plan	Yes or No	No

* *not applicable to reports to Licensing, Development Control and Area Development Committees*

Part 3

These sections must be completed by the author of the Report.

Does the proposal have implications for the following Directorates? If so, please inform the relevant Director.		Please give details as appropriate
Chief Executive/Corporate Services	Yes or No	No
Education Services	Yes or No	No
Environment Services	Yes or No	No
Social Services	Yes or No	No
Strategic Services	Yes or No	No

Part 4

Is the proposal contrary to or does it propose amendment to the Policy Framework or contrary to (or not wholly in accordance with) the Council's budget?	Yes Fill in Box 1	No Fill in Box 2
1. Details of the nature and extent of consultation with stakeholders and relevant select committees.		
2. Details and outcome of consultation, as appropriate.		

Part 5

Is the proposal a Key Decision in relation to an Executive function?	Reference Number	No

Part 6

Wards

Appendices

Appendix 1 Interest Rate Forecasts
Appendix 2 Economic Factors Affecting UK Interest Rates
Appendix 3 Borrowing Maturity Profile
Appendix 4 List of Authorised Deposit Takers
Appendix 5 Schedules to the Treasury Management Practices

Documents available in Members' Room

Background Papers:

The following documents/files were used to compile this report:

INTEREST RATE FORECASTS Appendix 1

The data below shows a variety of forecasts published by a number of institutions. The first three are individual forecasts including those of UBS and Capital Economics (an independent forecasting consultancy). The final two represent summarised figures drawn from the population of all major City banks and academic institutions. The forecast within this strategy statement has been drawn from these diverse sources and officers' own views.

1. INDIVIDUAL FORECASTS

Sector View interest rate forecast – December 2003

(%)	Q4 2003	Q1 2004	Q2 2004	Q3 2004	Q4 2004	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006
Base Rate	3.75%	4.00%	4.00%	4.25%	4.25%	4.50%	4.50%	4.50%	4.50%	4.50%
5yr Gilt Yield	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%
10yr PWLB	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
25yr PWLB	5.00%	4.75%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%

UBS Economic interest rate forecast (for quarter ends) - December 2003

(%)	Q4 2003	Q1 2004	Q2 2004	Q3 2004	Q4 2004	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006
Base Rate	3.75%	4.00%	4.00%	4.25%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
10yr PWLB	5.15%	5.15%	5.15%	5.25%	5.25%	5.40%	5.40%	5.40%	5.40%	5.40%
25yr PWLB	5.20%	5.25%	5.35%	5.45%	5.45%	5.65%	5.65%	5.65%	5.65%	5.65%

Capital Economics interest rate forecast – December 2003

(%)	Q4 2003	Q1 2004	Q2 2004	Q3 2004	Q4 2004	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006
Base Rate	3.75%	4.00%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.50%
5yr Gilt Yield	4.90%	5.10%	5.00%	4.80%	4.50%	4.40%	4.40%	4.50%	4.50%	4.80%
10yr PWLB	5.25%	5.35%	5.25%	5.15%	4.85%	4.75%	4.75%	4.85%	4.85%	5.05%
25yr PWLB	5.05%	5.05%	5.05%	5.05%	4.95%	4.85%	4.95%	4.95%	4.95%	4.95%

2. SURVEYS OF ECONOMIC FORECASTS

HM Treasury - summary of 35 independent forecasters views of **base rate** – as at November 2003
(2004 – 2007 are as at Aug 2003 but are based on 11 forecasts)

(%)	2003	2004	2005	2006	2007
	Year end	Year end	Average	Average	Average
Average	3.67%	4.27%	4.78%	5.05%	4.93%
Highest	3.90%	5.00%	5.72%	5.60%	5.60%
Lowest	3.48%	3.14%	4.00%	3.81%	3.84%

Consensus Forecasts - summary view of 25 city houses on the likely change in short term and 10 year fixed interest rates (November 2003)

(%)		Nov– 03	Feb - 04	Nov – 04
3 month interbank –	aver	3.88%	3.70%	4.10%
	High	3.88%	4.00%	4.70%
	Low	3.88%	3.50%	3.30%
10yr PWLB Rate –	aver	5.20%	4.85%	4.95%
	High	5.20%	5.15%	5.55%
	Low	5.20%	4.45%	4.25%

Appendix 2

ECONOMIC FACTORS AFFECTING UK INTEREST RATES

Shorter-term rates – Base rate was cut by 0.25% in July 2003, to a new 48-year low of 3.5% due to hesitant recovery after the Iraq war and a climbing pound. With hindsight, this now appears to have been an over cautious move by the Monetary Policy Committee (MPC) as this cut was reversed in November. However, the Chancellor announced a switch of inflation target for the MPC in the Pre Budget Report in December 2003 from plus or minus 1% around 2.5% on RPIX to plus or minus 1% around 2% on CPI (consumer prices index; this was formerly known as the harmonised index of consumer prices). CPI has been running at 1.1 – 1.6% throughout 2003 and is forecast to average 1.4% in 2003, 1.7% in 2004 and 1.4% in 2005 i.e. below the likely target. In addition, wage inflation and producer price inflation are running at benign levels and oil prices are likely to come down from current high levels. There is therefore likely to be little inflationary pressure to raise base rate. In addition, the upside potential for base rate is limited by the heightened sensitivity of consumers to interest rate rises due to the huge increase in personal borrowing in recent years e.g. an increase in base rate from 3.5% to 4.5% is an increase of 29% in likely borrowing rates. In view of the likely fragility of consumer demand in 2004 in the UK, and due to the likelihood of growth in the US falling back in 2004 to only a modest rate and weak growth expected in the Eurozone in 2004, it is expected that base rate will only rise to 4.25% by the end of 2004 after being at 4.0% for most of the year.

Longer-term interest rates – PWLB rates were at low levels during the first half of 2003 due to investor fears over the Iraq war which depressed share values and gilt yields. Equity values have increased by about 25-30% from the low point to which they plummeted before the Iraq war, on expectations that the surge in economic recovery in the second half of 2003 will last well into 2004 and beyond and so boost corporate earnings. Gilt prices have consequently fallen, causing increases in gilt yields and long-term PWLB rates which incurred a sharp unexpected increase in October 2003 on a surge in optimism on US economic recovery; this pushed the PWLB 20-25 year lower quota rate up to 5.0% - 5.15% and it is forecast that this rate will stabilise around 5.0% for most of 2004/05. A rise in long-term PWLB rates to more normal levels with the 20-25 year lower quota rate returning consistently to the band of 5.00% – 5.40% looks unlikely in 2004/05.