

SUPPLEMENTARY AGENDA 1

ASSEMBLY

Wednesday, 27 February 2008

**Agenda Item 6. Report of the Corporate Director of Resources:
Treasury Management Annual Strategy and the
Council's Prudential Indicators (Pages 1 - 24)**

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THE ASSEMBLY

27 FEBRUARY 2008

REPORT OF THE CORPORATE DIRECTOR OF RESOURCES

Title: Treasury Management Annual Strategy Statement, Prudential Indicators and Annual Investment Strategy		For Decision
Summary		
<p>The production and approval of a Treasury Management Annual Strategy Statement and Annual Investment Strategy are requirements of the Council under Section 15(1) of the Local Government Act 2003. It is also a requirement of the Act to set an authorised borrowing limit for the forthcoming financial year.</p> <p>The Local Government Act 2003 also requires the Council to have regard to the Prudential Code, and to set Treasury Management prudential indicators which take into account the Council's capital investment plans for the next 3 years.</p> <p>At its meeting on 19 February 2008 (Minute 119 refers), the Executive agreed to recommend the Treasury Management Annual Strategy, Annual Investment Strategy, and a borrowing limit for 2008/09 of £150 million to the Assembly for agreement.</p>		
Recommendation		
<p>The Assembly is recommended to agree:</p> <ol style="list-style-type: none"> 1. An authorised borrowing limit of £150 million for 2008/09; 2. The Treasury Management Annual Strategy and Annual Investment Strategy as set out in Appendix 1; and 3. The Treasury Management Prudential Indicators for 2008/09 to 2010/11 as set out in Appendix A. 		
Reason		
<p>In order for the Council to meet the relevant requirements of the Local Government Act 2003.</p>		
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Background Papers

Executive report and minutes, 19 February 2008

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THE EXECUTIVE

19 FEBRUARY 2008

REPORT OF THE CORPORATE DIRECTOR OF RESOURCES

TREASURY MANAGEMENT ANNUAL STRATEGY STATEMENT, POLICY , PRUDENTIAL INDICATORS, ANNUAL INVESTMENT STRATEGY AND BORROWING STRATEGY	For Decision
<p>Summary This report deals with the Treasury Management Annual Investment Strategy Statement, Prudential Indicators, Annual Investment Strategy and borrowing limits, in compliance under section 15 (1) (a) of the Local Government Act 2003 for consideration by the Executive.</p> <p>The production and approval of a Treasury Management Annual Strategy Statement and Annual Investment Strategy are requirements of the Council under Section 15(1) of the Local Government Act 2003. It is also a requirement of the act to set an authorised borrowing limit for the forthcoming financial year.</p> <p>The Local Government Act 2003 also requires the Council to have regard to the Prudential Code, and to set prudential indicators which take into account the Council's capital investment plans for the next 3 years.</p> <p>Wards Affected All wards.</p>	
<p>Recommendation(s) The Executive is asked to consider and refer the following to the Assembly on 27 February 2008 for approval:</p> <ol style="list-style-type: none"> 1. The Treasury Management Strategy Statement for 2008/09 (this document); 2. The authorised borrowing limit of £150 million for 2008/09, which will be the statutory limit determined under section 3(1) of the Local Government Act 2003 (section 2). 3 The Borrowing Strategy for 2008/09 (section 7) 4 The Annual Investment Strategy for 2008/09, which states the investments that the Council may use for the prudent management of its investment balances (section 8). 5. The Treasury Management Prudential Indicators for 2008/09 (Appendix A). 	
<p>Reason(s) It is necessary for the Members to approve this report due to the requirements of the Local Government Act 2003 as stated above.</p>	
<p>Financial Implications The aim of this treasury management strategy is to maximise the Council's financial</p>	

resources. Detailed financial considerations are considered throughout this document.		
Legal Implications It is a legal requirement for the Council to set an annual treasury management strategy, as set out in the Local Government Act 2003.		
Risk Management There are no further risks issues other than those already detailed in this report.		
Social Inclusion and Diversity As this report does not concern a new or revised policy, there are no specific adverse impacts insofar as this report is concerned.		
Crime and Disorder This report has given careful consideration to the implications of Section 17 of the Crime and Disorder Act 1978 and there are no specific implications insofar as this report is concerned.		
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1. Introduction

- 1.1 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.
- 1.2 The Act therefore requires local authorities to set out their 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.
- 1.3 The Department of Communities and Local Government's (DCLG) investment guidance states that authorities could combine the Treasury Strategy Statement and Annual Investment Strategy into one report; the Council has adopted that suggestion and the Annual Investment Strategy is therefore included in section 7.
- 1.4. The 2008/09 strategy covers:
 - The Treasury Management Policy;
 - Treasury limits in force which will limit the treasury risk and activities of the council;
 - Treasury Management Prudential Indicators;

- The current treasury position and borrowing requirement;
- Prospects for interest rates;
- The borrowing strategy;
- The investment strategy,
- End of year investment report; and
- Use of External Fund Managers.

1.5 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 increases in capital expenditure must be limited to a level whereby increases in capital charges to revenue from any increases in interest charges caused by increased 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.

2. Treasury Management Policy

- 2.1 The Council defines the policies and objectives of its treasury management activities as the management of the authority's cash flows, its banking, money and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance with those risks
- 2.2. The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will focus on their risk implications for the Council.
- 2.3 The Council is aware that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

3. Treasury Management Prudential Indicators and Treasury Limits

- 3.1. 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 Act specifies that Councils must have regard to CIPFA's Prudential Code for Capital Investment. This code sets a range of indicators in respect of Treasury Management. A key indicator is the Authorised Borrowing Limit. In setting this limit, the Council must have regard to the Prudential Code by ensuring 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'.

The code defines this limit as a limit gross of its total external debt, gross of investments, separately identifying borrowing from other long term liabilities.

- 3.2. It is proposed that the 'Authorised limit' remain at £150m for the years 2008/09 to 2010/11. The capital programme report that is also being considered on this agenda is proposing a total capital programme that will lead to a borrowing requirement of around £80m to £90m over the next 3 years. This will fund projects such as the corporate accommodation strategy (circa £20m), highways maintenance (£20m), IT infrastructure (£11m), Becontree Heath Leisure Centre (£10m), Valence House (£5.5m) and a range of other capital schemes.
- 3.3. As this is a legal limit, sufficient headroom has been provided to ensure that any major capital investment projects where financing has yet to be finalised, such as Housing Futures, are not restricted by this statutory limit. This limit would cover any short term borrowing for cashflow purposes as well as long term borrowing for capital projects.
- 3.4. The code also requires the local authority to set an operational limit for the 2008/09 financial year and the following two financial years for its total external debt, gross of investments, separately identifying borrowing from other long term liabilities. The operational limit is the level at which the Council would actually need to borrow in any one year to meet its capital financing requirements for the capital programme.
- 3.5. Further details on the Council's Treasury Indicators have been included in Appendix A to this document.

4. Current Portfolio Position Investments

- 4.1. The table below shows the Council's current treasury portfolio position for the first three quarters of 2007/08 to 31 December:

	31 March 2007	31 December 2007
	£ Million	£ Million
Council in House Team	40.5	75.8
Scottish Widows	20.7	21.5
Investec Asset Management	57.7	34.5
Borrowing	nil	Nil
Total	118.9	131.8

- 4.2. Each year, Council Officers consult with its treasury management advisor Sector to determine appropriate benchmarks for investment returns. External fund managers have been informed of these proposed benchmarks and have set their investment strategies accordingly. They are as follows:

	2008/09 Benchmark	Reason
<ul style="list-style-type: none"> Investec Asset Management 	5.5% (or 3 month LIBID, whichever is higher)	<ul style="list-style-type: none"> Bank Rate now 5.5% as at January 2008 Bank Rate Forecast to remain within the range of 5.5% and 5.0% Maximising of council's return on investments at minimal risk Maximisation of the Council's returns in order to meet budget pressures
<ul style="list-style-type: none"> Scottish Widows 	5.75%, (or 3 month LIBID, whichever is higher)	

4.3 The 2008/09 benchmarks for Investec has remained at the higher of 5.5% and 3 month LIBID while the benchmark for SWIP has changed from the higher of 5.5% and 3 month LIBID to the higher of 5.75% and 3 month LIBID. The investment strategy of SWIP is such that they take more risk within this portfolio than is the case with Investec. As such, their benchmark is set at a higher level. However, the risk undertaken is within acceptable risk parameters.

4.4 Benchmarks are set to ensure that the council maximises its return on investments, provide sufficient challenge to fund managers, and ensure that the treasury management strategy is in line with the budget strategy. It also takes into account the effect of future projections for interest rates.

5. Prospects for Interest Rates

5.1. The level of, and fluctuations in, interest rates, are a key consideration for any treasury management strategy. The Council invests its portfolio throughout the year, and the level of interest rates determines the interest receipts that are generated to support ongoing revenue expenditure.

5.2. To arrive at an expectation of interest rates for 2008/09, and beyond, a number of judgements and assumptions are made; in addition this involves a degree of uncertainty.

5.3. 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. Appendix B draws together a number of current City forecasts for short term or variable and longer fixed interest rates.

5.4 It is expected that rates in 2008/09 will take a downward trend from the current level of 5.25% with expectations tending towards a further 0.25% cut in quarter 1/quarter 2 in 2008 before the Bank Rate stabilises for the next two years.

5.5. The Council has set the external and internal fund managers challenging targets and would expect a higher rate of return than merely matching the base rate.

6. Borrowing and Borrowing Strategy

- 6.1 The Council does not anticipate to borrow in 2007/08, its capital expenditure will be financed directly through Government grants and capital receipts. However, it is anticipated that in 2008/09 and beyond the Council will have to borrow to finance capital expenditure. In addition to those projects already underway, there are significant projects that require the Council to consider funding options in the longer term. They include Housing Futures, the Corporate Accommodation Strategy and a number of other projects designed to meet the Council's regeneration and customer first agendas.
- 6.2. There may also be instances where there is a business benefit of borrowing. For example, the construction of a car park could be financed by a loan, while the longer term income received on this asset would make the borrowing economically viable.
- 6.3. The borrowing decision is a treasury management decision and there is a key objective of trying to borrow as low as possible within the interest rate cycle in order to secure long term funding for capital projects at affordable borrowing rates.
- 6.4. Borrowing Objectives: Reducing the revenue cost of borrowing to its minimum and appraisal of new sources of finance and loan instruments in order to achieve minimum risk while having regard to the maturity profile of loans is key due to the impact that these factors have on the authority's revenue budgets. The authority must consider borrowing fixed rate funds when interest rates are low and variable rates when borrowing or investment cash rates are high and expected to go lower. In addition the Council may have to fund known capital needs ahead of that need in order to take advantage of lower fixed term rates and market opportunities. Currently the market is expecting interest rates to fall.
- 6.5. Borrowing Options: The decision to borrow is being taken in consultation with our expert treasury advisors. A mix between Public Works Loans Board (PWLB) and money market loans is recommended by our treasury management advisers. In addition there may be instances where short term borrowing is advantageous from an overall treasury management point of view.
- 6.6. Portfolio Mix: The Council's treasury management advisers have recommended a 50/50 split in the debt portfolio in the long term. It is advised that at each point in time the Council should have a portfolio where no more than 10% of its debt matures in any one year. However at the onset of building its debt portfolio the Council would have 100% maturities as 100% of its debt would be from one particular source. This highlights the importance of building a portfolio of debt.
- 6.7. Risk Evaluation: The Council will borrow in tranches as the opportunities arise in the market in order to reduce its financing risk. The Council continues to dedicate resources with its treasury management advisers to evaluate the prospects and effect of borrowing.
- 6.8. Other Considerations: As the Council continuously evaluates and updates its capital programme needs the decision to borrow and the amount to borrow will also be evaluated to follow suit as the potential to borrow may increase once new capital schemes are approved.

6.9. Portfolio Life: In any debt portfolio there will be a range of maturities out as far as 70 years. As part of the proactive management of the debt portfolio these loans will be considered for debt restructuring through monitoring and where a financial benefit can be made, debt will be restructured within acceptable risk parameters in the treasury management strategy. The debt maturity profile will not stay static because when opportunities arise they are taken in order to reduce the council's underlying financing costs which will impact on the revenue budget.

6.10 The table below indicates the estimated range of total borrowing requirement (cumulative) from 2008/09 to 2010/11:

	2008/09 £m Estimate	2009/10 £m Estimate	2010/11 £m Estimate
TOTAL	45-55	65-75	80-90

6.11 A borrowing limit of £150m has been set per paragraph 3.1. This limit would apply to both short term and long term borrowing, and would be used to address cashflow issues in the short term, and capital financing issues in the longer term.

6.12 The borrowing rate forecast for 2008/09 from the Council's treasury management advisers is based around an expectation that there will normally be variations of +/- 25bps during each quarter, this is as follows:

- The 50 year PWLB rate is expected to fluctuate by 0.05% between quarters in 2008/09, Q1 4.5%, Q2 4.45%, Q3 4.45% and Q4 4.45%.
- Similarly, the 25 year PWLB rate is expected to fall progressively from 4.65% to 4.5% in Q4%
- The 10 year PWLB rate is expected to fall from 4.7% in Q1 2008 to 4.55% in Q3, followed by a gradual rise.
- The 5 year PWLB rate is expected to fall from 4.7% in Q1 2008 to reach 4.55% in Q3 2008 and to then gradually rise.
- The forecast indicates, that the borrowing strategy for 2008/09 should be set to take 20 – 30 year borrowing. However it should be noted that attractive rates could be available at any time in the year when there is a dip down in rates.
- The Council currently has no debt and would be at a point in 2008/09 where by a portfolio is being built, it is therefore on that back ground that debt rescheduling has not been considered in full detail. However where in future the Council is to reschedule its debt due to a need to generate cash savings and / or discounted cash flow savings or to help fulfil the strategy or enhance balance of the portfolio then all rescheduling will be reported to the Executive and considered on the adviser of the treasury management advisers.

7. ANNUAL INVESTMENT STRATEGY

Investment Policy

7.1 The Council must have regard to the DCLG's Guidance on Local Government Investments ("the Guidance") issued in March 2004 and the Chartered Institute of Public Finance Accountants (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

The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The ability to get access to funds when they are required is also key.

7.2 Under the requirements of the Investment Guidance issued by the Department of Communities, investments need to be classified into specified and Non-Specified. The Annual Investment Strategy states which investments the Council may use for the prudent management of its treasury balances during the financial year under the headings of Specified Investments and Non-Specified Investments. It is a requirement to report these investments to the Executive for approval. These are listed in Appendix C. It also sets out:

- The procedures for determining the use of each asset class (advantages and associated risk), particularly if the investment falls under the category of “non-specified investments”; and
- The maximum periods for which funds may be prudently committed in each asset class is also listed in Appendix C.

7.3 For 2008/09, the strategy has been amended so that the Council can invest in products which will maximise investments returns, hence the Council would maintain a mixed portfolio of investments in 2008/09. Where the maximum returns can be achieved and on the advice of our advisers, we may seek to invest in callable investment products and other structured products. In addition our external fund managers may seek to invest in pooled money market funds with permitted weighted average maturity of less than 1 year so can be classified as specified investments. Gilts investments will continue to remain on a segregated basis.

Investment Objectives

7.4 All investments will be in sterling. The general policy objective for this Council is the prudent investment of its treasury balances. The Council’s investment priorities are the security of capital and liquidity of its investments. The Council will aim to achieve the optimum return on its investments commensurate with the proper levels of security and liquidity. We have set challenging targets for 2008/09, and the risk of balancing returns with prudence will need to be managed.

7.5 The DCLG maintains that the borrowing of monies purely to invest or on-lend and make a return is unlawful and the Council will not engage in such activity.

Security of Capital: the use of Credit Ratings

7.6 Barking and Dagenham relies on credit ratings published by Fitch and Moody to establish the credit quality of counterparties (issuers and issues) and investment schemes. The Council has also determined the minimum long-term, short-term and other credit ratings it deems to be “high” for each category of investment.

7.7 Monitoring of credit ratings:

- All credit ratings will be monitored monthly. The Council has access to Fitch credit ratings and is alerted to changes through its use of the Sector website;

- If a counterparty's or investment scheme's rating is downgraded with the result that it no longer meets the Council's minimum criteria, the further use of that counterparty /investment scheme as a new investment will be withdrawn immediately. The Council will also immediately inform its external fund managers of the withdrawal of the same;
- If counterparty is down graded but still meets the Council's minimum criteria, it would be watched closely and any further downgrading would result in the Council removing it from its lending list;
- If a counterparty is upgraded so that it fulfils the Council's criteria, its inclusion will be considered and put to the Divisional Director of Corporate Finance for approval;
- The Council will establish with its fund managers their credit criteria and the frequency of their monitoring of credit ratings so as to be satisfied as to their stringency and regularity; and
- The Council will continue its approach of investing no more than 20% of its aggregate funds to any particular counterparty or £15m which ever is higher. However there may be exceptional circumstances with the Council's call account with bank of Scotland where it is advantageous and where the risk has been assessed as being minimal to invest more than the approved limits, where this is done the Divisional Director Corporate Finance will be notified.

Investment balances / Liquidity of investments

7.8 The sum invested broadly represents the capital receipts that the Council has not yet re-invested into capital projects, financial reserves and provisions, together with the impact of any difference between the collection of income and council expenditure. These figures are based on delivery of the current approved capital programme as outlined in the Council's capital strategy.

31 March	Council's Investment Fund Balance	
	Actual (£'m)	Forecast (£'m)
2005	187	
2006	154	
2007	117	
2008		113
2009		101

7.9 Based on its cash flow forecasts, the Council anticipates its fund balances by 31 March 2008 to be approximately £113 million. This is based upon the 2007/08 capital programme expenditure profile (including a prudent allowance for slippage) and both agreed and forecast use of reserves and other balances.

7.10 The table below shows a run down in the Council's level of investments as it delivers the capital programme and, for the first time in a number of years, new borrowing from 2008/09 onwards.

	31 March 2007 Actual £m	31 March 2008 Estimate £m	31 March 2009 Estimate £m	31 March 2010 Estimate £m	31 March 2011 Estimate £m
Investments					
Total Investments at 31 March	117	113	101	87	87
External Debt					
Borrowing	0	0	50	70	85
Other long term liabilities	0	0	0	0	0
Debt at 31 March	0	0	50	70	85
Annual change in debt	0	0	50	20	15
Borrowing costs for financial year	0	0	1.8	3.3	4.1
Total Investments less Total Debt	117	113	51	17	2

7.11 The Council may permit its external fund managers to use instruments such as gilts, bonds, pooled funds, callable investments and other longer-dated instruments. Limits will have to be established in the use of such instruments to ensure that the Council can have access to its investments to finance the capital programme. These Treasury Management limits can be set as either a £ amount or percentage.

7.12 Giving due consideration to the Council's level of balances over the next 3 years, the need for liquidity, its spending commitments and provisioning for contingencies, the Council has determined that £40m of its overall fund balances can be prudently committed to longer term investments (i.e. those with a maturity exceeding a year).

Investments defined as capital expenditure

7.13 The acquisition of share capital or loan capital in any body corporate is defined as capital expenditure under Section 16(2) of the Local Government Act 2003. Such investments will have to be funded out of capital or revenue resources and will be classified as 'non-specified investments'.

7.14 A loan or grant by this Council to another body for capital expenditure by that body is also deemed by regulation to be capital expenditure by this Council. It is therefore important for this Council to clearly identify if the loan has made for policy reasons (e.g. to the registered social landlord for the construction/improvement of dwellings) or if it is an investment for treasury management purposes. The latter will be governed by the framework set by the Council for 'specified' and 'non-specified' investments.

Provisions for Credit-related losses

7.15 If any of the Council's investments appeared at risk of loss due to default, (i.e. this a credit-related loss and not one resulting from a fall in price due to movements in interest rates) the Council will make revenue provision of an appropriate amount.

7.16 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.

7.17 The Council's external fund managers will comply with the Annual Investment Strategy. The agreements between the Council and the fund managers also stipulate guidelines on duration and other limits in order to contain and control risk.

8. Investment Strategy

8.1. The principles of the proposed strategy for 2008/09 are as follows:

- The weighting of the funds between the different fund managers which may occur as a result of requesting for money back will be kept under review in order to ensure that an adequate spread of risk is maintained within the smaller portfolio;
- To minimise interest rate risk and maintain balances between short and long term in order to accommodate interest rate risks; and
- External investments will be managed in accordance with the policy guidelines set out in the management agreements with each of the fund managers. These demand the securing the highest rate of return commensurate with the maintenance of the capital value of the investment.

8.2. Treasury Advisor Outlook: The Council's treasury management advisors Sector are forecasting that the bank rate has started a downward trend from 5.5% in December 2007 to 5.25% in February 2008 and 5.00% in Q2; it is then expected to remain unchanged for the next two years. The Council will therefore seek to lock in longer period investments at higher rates before this fall starts for some element of its investment portfolio which represents its core balances.

8.3. 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 and where a borrowing option is cheaper seek to consider such options.

9 Use of External Fund Managers

9.1 It is the Council's policy to use external fund managers for part of its investment portfolio. The fund managers will use both specified and non-specified investment categories, and are contractually committed to keep the Council's investment strategy. The level of external balances is under constant review as the level of capital receipts diminishes. The performance of each manager is reviewed monthly by the Chief Financial officer and quarterly in accordance with the treasury management adviser.

9.2 The Council currently uses two fund managers, Scottish Widows (SWIP) and Investec Asset Management. £55m of the Council's funds are currently managed on a discretionary basis by Investec and Scottish Widows. £25million was withdrawn from Investec in 2007. If and when there is a need to change the mix of

managers or to completely withdraw funds from a manager or to alter their investment parameters, a further report will be made to members.

- 9.3 **Investec** provides the Council with a periodic outlook on interest rates. They estimate three different scenarios for returns. The worst case is 5.00%, the central case is 5.25% and best case is 5.50%. These scenarios are based on the recent trend of the MPC who are seen to be flagging up much more dovish policies for the New Year with at least two further rate cut seeming as inevitable as they see the risk of below trend growth as a greater threat to the UK economy than that of inflation. Secondly 3 month LIBOR has fallen from 6.6% to below 6% in the past few weeks and we have also seen significant reductions in longer LIBOR levels.
- 9.4 Investec believe that it is too soon to say that the credit crunch is over but they do, nonetheless, believe that the severe illiquidity witnessed in the shorter end of the money markets in the past few months will not return. Accordingly their 2008/9 forecasts do not need to repeat a scenario which assumes that the credit squeeze continues into 2008 at the worst of the levels seen last year. They anticipate at least two further rate cuts in 2008 (which are already more than priced in the markets) we have made reductions to our forecasts for 2008-9. Forecasts for the current year have not changed.
- 9.5 **Scottish Widows** also provide the Council with a forecast of their returns on the Council's investments based on two strategy options, 110% and 115%, the latter representing a higher risk strategy. The fund manager is currently pursuing the 115% strategy and expects to achieve a return of at least 5.75% for 2008/09.

10. End of year Investment Report

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

11. Consultees

- 11.1 The officers consulted on this report are:
Joe Chesterton – Divisional Director of Corporate Finance
John Hooton – Group Manager Accounting & Technical Finance
Lee Russell – Group Manager, Resources & Budgeting Finance
Miriam Adams – Treasury & Pension Manager
External – Sector Treasury Services

Background Papers:

Local Government Act 2003
CIPFA – The Prudential Code for Capital Finance in Local Authorities
CIPFA – Treasury Management in the Public Services
Approved capital programme 2007/08 to 2009/10
Monthly Treasury Management Report
Medium Term Financial Strategy 2007/08 to 2009/10

The Prudential Code for Capital Investment in Local Authorities

1. Introduction.

- 1.1. The Prudential Code for Capital Investment was introduced in April 2004 as part of the Local Government Act 2003. The Prudential Code for Capital Investment allows each council freedom over its level of capital expenditure so long as it is prudent, affordable and sustainable. In order to show it is working within these limits the Council must approve, revise and monitor a range of indicators.
- 1.2. To enable councils to establish whether their proposed borrowing is affordable and prudent the Chartered Institute of Public Finance and Accountancy (CIPFA) has produced The Prudential Code for Capital Finance in Local Authorities. This identifies a range of indicators which must be considered by the Council when it makes its decisions about its future capital programme and sets its budget.
- 1.3. The Prudential Code prescribes a number of **Treasury Indicators**. This appendix deals with the following indicators:
 - PI (prudential indicator) 10 – Authorised Borrowing Limit
 - PI 11 – Operational Borrowing Boundary
 - PI 13 – Adoption of the CIPFA Treasury Management Code
 - PI 14 – Fixed Interest Exposure
 - PI 15 – Variable Interest Exposure
 - PI 16 – Maturity Structure of Borrowing
 - PI 17 – Investments over 364 days

2. External Debt

- 2.1 In the medium term local authorities only have the power to borrow for capital purposes. The current position is that the Council will embark on borrowing in 2008/09.
- 2.2 External borrowing and investment arises as a consequence of all the financial transactions of the Council and not simply those arising from capital spending. In accordance with best professional practice the Council does not associate borrowing with particular items or types of expenditure. This means that in day to day cash management no distinction can be drawn between revenue or capital funds nor, similarly, between Housing Revenue Account and the General Fund. It should be noted that the code requires that off-balance sheet private finance initiative (PFI) schemes will be treated as outside the prudential indicator for debt, by absorbing revenue resources, they will have to be taken into account in determining the proposed level of capital investment is affordable.
- 2.3 **The authorised limit** – This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by members. It reflects the statutory limit determined under section 3 (1) of the Local Government Act 2003.

- 2.4 **The operational limit** – This represents a limit beyond which external debt during the course of the year; it is not a limit. Actual external debt could vary around this boundary for short times during the year. It should act as a monitor indicator to ensure the authorised limit is not breached. The limit is usually lower than the authorised limit.
- 2.5 At any point in time there are a number of cash flows in and out of the Council’s bank account which are caused by the differential timing of payments and receipts from the Council. It is possible that an unanticipated cash movement could lead to a requirement for temporary borrowing. Such decisions will need to take into account the affordability of borrowing, but it is important that the operational boundary leave sufficient “headroom” for these eventualities.
- 2.6 The difference between the authorised limit and operational boundary for borrowing is that the authorised limit includes a head room for borrowing for future known capital needs now. However the Council will only do so if it expected long term borrowing rates to rise significantly before 2009/10 – 2011/12.
- 2.7 For this reason the Executive is recommended to approve the authorised limits and operational boundary limit set out in Table 1.

3. Prudential Indicators

Table 1: Operational Limit and Authorised Borrowing Limits (Prudential Indicators 10 and 11)

	2007/08 £'million	2008/09 £'million	2009/10 £'million	2010/11 £'million	2011/12 £'million
Borrowing	0	50.0	70.0	85.0	85.0
Other long-term liabilities	Nil	Nil	Nil	Nil	Nil
Operational Boundary on Borrowing	0	50.0	70.0	85.0	85.0
Authorised Limit (affordable limit)	150.0	150.0	150.0	150.0	150.0

- 3.1 These limits give the Chief Financial Officer authority to undertake borrowing for cash flow purposes. For this reason, in taking its decisions on this budget report, the Council is asked to note that the authorised limit for 2008/09 will be the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Adoption of the CIPFA Treasury Management Code (Prudential Indicator 13)

- 3.2 The authority has an integrated treasury management strategy and has adopted the CIPFA Code of Practice for Treasury Management in the Public Sector. Treasury management creates the link between an authority's CFR and the structure of its external debt. Like the operational boundary, these are of direct relevance to day to financial management.
- 3.3 The new Prudential Code for Capital Finance in Local Authorities supplements this by requiring council's to calculate specific indicators to demonstrate the prudence of its treasury management policies. These are detailed below:

Fixed Interest Exposure (Prudential Indicator 14)

- 3.4 Currently borrowing has been only in the short term for cashflow purposes; there has not been any need for the authority for exposure to long term exposure to fixed interest rates on borrowing. This indicator will be reviewed in detail once the Council commences borrowing in 2008/09.

Variable Interest Exposure (Prudential Indicator 15)

- 3.5 The Council will not be exposed to variable interest rate risk since all its borrowing will be at known overdraft rates (if this occurred) and fixed rates.

Maturity Structure of Borrowing (Prudential Indicator 16)

- 3.6 This prudential indicator deals with projected borrowing over the period and the rates that they will mature over the period. As the Council currently does not have a debt portfolio, and rates suggest that it is advantageous to borrow over a term between 25 – 30 years, all long term borrowing taken is expected to be over a period of more than 25 years except as otherwise advised by treasury management advisers.

Investments over 364 days (Prudential Indicator 17)

- 3.7 The overriding objective of the investment strategy is to ensure that funds are available on a daily basis to meet the Council's liabilities. The risk inherent in the maturity structure of the Council's investments is that it may be forced to realise an investment before it reaches final maturity and thus at a time when its value may be dependent on market conditions that cannot be known in advance. Taking into account the current level of investments, and future projections of capital expenditure, the following limits will be applied to sums invested:

Table 2: Principle Sums Invested

	2007/08 £'million Estimate	2008/09 £'million Estimate	2009/10 £'million Estimate	2010/11 £'million Estimate
Total Investments (average)	113	101	87	87
Maximum invested over 1 year	28	40	40	0
Maximum invested over 2 years	0	40	0	0
Maximum invested over 3 years	0	0	0	0

3.8 These limits are derived from current projections on interest receipts and spending on the capital programme. They also include a level of contingency to take into account an element for new capital bids, and potential shortfalls in receipts from the disposals programme.

4. Summary Assessment

4.1 The Prudential Indicators confirm that the proposed treasury management strategy, in conjunction with the Council's budget strategy and capital programme, is in compliance with the key themes of the Prudential Code, those being prudence, affordability and sustainability.

4.2 The Council needs to confirm it is happy with the arrangements, whereby the Chief Financial Officer has authority, in exceptional circumstances, to borrow up to £150 million. It is anticipated that in practice that such borrowing is unlikely to be necessary.

4.3 The treasury management indicators will be regularly monitored throughout 2008/09.

INTEREST RATE FORECASTS

Sector Treasury Services compile forecasts on interest rates that are key considerations for the Council's Treasury Management Strategy. 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 one represents summarised figures drawn from the population of all major City banks and academic institutions. The various forecasts reflect the current volatility in the bank rates which was as a result of the subprime mortgage effect in the US in August 2007 and collapse of the US stock market in January 2008. As the Council is likely to borrow in 2008/09, the Council continues to make itself aware of the risks involved in borrowing and has consulted extensively with Sector with regards to this.

The forecast within this strategy statement has been drawn from these diverse sources.

1. INDIVIDUAL FORECASTS – INVESTMENTS AND BORROWING

Sector View interest rate forecast – 31.01.2008

Sector's view is that the bank rate started on a downward trend from 5.75% to 5.5% in December 2007, to be followed by further cuts in Q1 2008 to 5.25% and to 5.00% in Q2 2008, then unchanged for the following years.

	Q/E4 2007 %	Q/E1 2008 %	Q/E2 2008 %	Q/E3 2008 %	Q/E4 2008 %	Q/E1 2009 %	Q/E2 2009 %	Q/E3 2009 %	Q/E4 2009 %	Q/E1 2010 %	Q/E2 2010 %	Q/E3 2010 %	Q/E4 2010 %	Q/E1 2011 %
Bank Rate	5.50	5.25	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
5 yr PWLB	4.80	4.70	4.65	4.55	4.55	4.60	4.70	4.75	4.80	4.80	4.80	4.85	4.85	4.85
10yr PWLB	4.80	4.70	4.60	4.55	4.55	4.55	4.55	4.60	4.70	4.75	4.75	4.80	4.80	4.80
25 yr PWLB	4.65	4.60	4.55	4.55	4.50	4.55	4.55	4.60	4.65	4.70	4.70	4.70	4.70	4.75
50 yr PWLB	4.55	4.50	4.45	4.45	4.45	4.45	4.45	4.50	4.50	4.55	4.55	4.55	4.55	4.60

UBS Economic interest rate forecast (for quarter ends) – 24.12.2007

	Q/E4 2007 %	Q/E1 2008 %	Q/E2 2008 %	Q/E3 2008 %	Q/E4 2008 %
Base Rate	5.50	5.25	5.00	4.75	4.50
10 yr PWLB	5.19	5.23	5.25	5.30	5.35
25 yr PWLB	4.70	4.75	4.80	4.85	4.90
50 yr PWLB	4.55	4.60	4.65	4.70	4.75

Capital Economics interest rate forecast – 24 December 2007

	Q/E4 2007 %	Q/E1 2008 %	Q/E2 2008 %	Q/E3 2008 %	Q/E4 2008 %	Q/E1 2009 %	Q/E2 2009 %	Q/E3 2009 %	Q/E4 2009 %
Base Rate	5.50	5.25	5.00	4.75	4.50	4.25	4.00	4.00	4.00
5yr PWL	4.65	4.45	4.35	4.05	3.95	4.05	4.25	4.35	4.75
10 yr PWL	4.65	4.45	4.25	4.15	4.15	4.25	4.45	4.65	4.85
25 yr PWL	4.65	4.55	4.45	4.45	4.35	4.45	4.55	4.75	4.95
50yr PWL	4.55	4.55	4.45	4.35	4.25	4.35	4.55	4.65	4.75

2. SURVEY OF ECONOMIC FORECASTS

HM Treasury – November 2007 summary of forecasts of 24 City and 13 academic analysts for Q4 2007 and 2007. (2009 – 2011 are based on 21 forecasts)

	Bank rate actual	Quarter ended		annual average bank rate		
		Q4 2007 %	Q4 2008 %	ave. 2009 %	ave. 2010 %	ave. 2011 %
Median base rate	5.75	5.80	5.30	5.24	5.22	5.26
Highest base rate	5.75	5.80	6.30	6.00	6.00	6.00
Lowest base rate	5.75	5.30	4.80	4.5	4.06	4.00

Economic background

Sector Treasury Services also provide the Council with economic information to support their views on interest rates. It is important that this information forms part of the basis upon which the Council's Treasury Management Strategy is informed by such information. This section summarises some of the key developments.

UK

- GDP: growth has been strong during 2007 and hit 3.3% year on year in Q3. Growth is expected to cool from 3.0% in 2007 as a whole to 2.0% in 2008.
- House prices started to decline on the downswing in Q3 2007 and this is expected to continue into 2008.
- The combination of increases in Bank Rate Banks have also tightened their lending criteria since the sub prime crisis started and that will also dampen consumer expenditure via credit cards and on buying houses through obtaining mortgages.
- Banks have also tightened their lending criteria since the sub prime crisis started and that will also dampen consumer expenditure via credit cards and on buying houses through obtaining mortgages.

International

- The US, UK and EU economies have all been on the upswing of the economic cycle in 2005 and 2006 and so interest rates were successively raised in order to cool their economies and to counter the build up of inflationary pressures.
- The US is ahead of the UK and EU in the business cycle and started on the downswing of the economic cycle during 2007. The Fed. Rate peaked at 5.25% and was first cut in September by 0.5% to 4.75%. This was a response to the rapidly deteriorating prospects for the economy in the face of the down turn in the housing market, the sub prime mortgage crisis and the ensuing liquidity crisis which started in August 2007 and has subsequently resulted in banks making some major write offs of losses on debt instruments containing sub prime mortgages. Banks have also tightened their lending criteria which has hit hard those consumers with poor credit standing.
- The Fed has cut its rate again, to 4.5% in October 2007 and to 4.25% in December and is expected to cut by another 0.25% to 0.75% by April 2008 to try to stimulate the economy and to ameliorate the extent of the downturn.
- EU growth has been strong during 2006 and 2007 but will be caught by the general downturn in world growth in 2008.

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Specified Investments:

The classification of investments as specified and non-specified is constantly reviewed. The Chief Financial Officer ensures that investment products are fully understood and the risks and compliance with CIPFA Code of Practice on Treasury Management is full appraised and understood.

All investments which fall under the classification of specified investments will be sterling denominated and have maturities up to maximum of 1 year, meeting the minimum 'high' rating criteria where applicable

	Minimum Credit Criteria	Use
Debt Management Agency Deposit Facility	Govt Backed-Not Credit Rated	In-house
Term deposits – UK government	Govt Backed-Not Credit Rated	In-house
Term deposits – other LAs	High Security – although not Credit rated	In-house
Term deposits – banks and building societies	Short-term F1,or equivalent, Support 1,2 or 3	In-house and fund managers
Certificates of deposits issued by banks and building societies	Short-term F1,or equivalent, Support 1,2 or 3	Fund managers
Callable deposits	Short-term F1, or equivalent, Support 1, 2 or 3	In – house and fund managers
Money Market Funds	AAA	In- house and Fund Managers
UK Government Gilts	AAA	Fund Managers
Gilt Funds and Bond Funds	long-term AA	Fund Managers
Treasury Bills	Govt Backed-Not Credit Rated	Fund Managers
Short term funds	AAA	Fund Managers
Pooled funds	AAA	Fund Managers

Non-Specified Investments:

A maximum of 75% will be held in aggregate in non-specified investments

	Minimum Credit Criteria	Use	Max % of total investments	Max. maturity period
Term deposits – UK government (with maturities in excess of 1 year)	Govt Backed-Not Credit Rated	In-house	25%	5 Years
Term deposits – other LAs (with maturities in excess of 1 year)	High Security – although not Credit rated	In-house	25%	5 Years
Term deposits – banks and building societies (with maturities in excess of 1 year)	Short-term F1, or equivalent, Support 1,2 or 3	In-house	25%	5 Years
Certificates of deposits issued by banks and building societies	Short-term F1, or equivalent, Support 1,2 or 3	Fund managers	75%	5 Years
UK Government Gilts with maturities in excess of 1 year	AAA	Fund Managers	75%	10 Years
Term deposits – callable deposits	Short-term F1, or equivalent, Support 1,2 or 3	In-house	25%	5 Years
Pooled Funds	Short-term F1, or equivalent, Support 1,2 or 3	Fund Managers	75%	5 Years
Bonds issued by multilateral development banks	AAA	In-house on a 'buy-and-hold' basis. Also for use by fund managers	75%	10 Years
Bonds issued by a financial institution which is guaranteed by the UK government		In-house on a 'buy-and-hold' basis. Also for use by fund managers	75%	10 Years
Sovereign bond issues (i.e. other than the UK govt)	AAA	Fund Managers	75%	10 Years