APPENDIX C

Treasury Management Strategy 2009/10 to 2011/12

For Consideration by Council 04 March 2009

Introduction

1. The treasury management function is an important part of the overall financial management of the Council's affairs. Its importance has increased as a result of the freedoms provided by the Prudential Code. Whilst the prudential indicators consider the affordability and impact of capital expenditure decisions, the function covers the effective funding of these decisions. There are also specific treasury prudential indicators included in this strategy that need approval.
2. The Council's activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). This Council adopted the Code of Practice on Treasury Management on 13 February 2002, and as a result adopted a treasury management policy statement. This adoption complies with the requirements of the first of the treasury prudential indicators.
3. The Code requires an annual strategy to be reported to Cabinet outlining the expected treasury activity for the forthcoming 3 years. A further report is produced after the year-end to report on actual activity for the year.
4. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury function.
5. This strategy covers:
   - The current treasury position
   - The expected movement in interest rates
   - The Council's borrowing and debt strategy (including its policy on making provision for the repayment of debt)
   - The Council's investment strategy (in compliance with the Department for Communities and Local Government guidance)
   - Specific limits on treasury activities

Treasury Position

6. The forecasted treasury position and the expected movement in debt and investment levels over the next three years are as follows.

Table 1: Gross external debt and investment forecast

	2009/10 Estimated	2010/11 Estimated	2011/12 Estimated
	£'000	£'000	£'000
EXTERNAL DEBT			
Borrowing	**39,200**	**39,200**	**39,200**
Other long term liabilities	**265**	**260**	**255**
Total Debt at 31 March	**39,465**	**39,460**	**39,455**
INVESTMENTS			
Total Investments at 31 March*	**9,600**	**12,900**	**12,900**

*this figure is inclusive of the £6m principal held with Icelandic banks.

The forecast position on external borrowing remains static across the three years, despite the fact that by the end of 2009/10 there will be a cumulative increase in the underlying need to borrow of £3.78M (made up of 2006/07 £1.608M, 2007/08 £1.762M, 2008/09 £1.811M, 2009/10 -£1.401M), for which no actual additional borrowing has been taken up. This is because the twin issues of the amounts set aside for the future repayment of debt, and a cashflow position that is forecast to remain relatively stable, mean that there is no immediate need to take out new loans.

Expected Movement in Interest Rates

7. The UK economy has entered a profound recession, worsened by a dangerous combination of negative growth and dislocation in the domestic and world financial markets. The situation in the economy is considered critical by the policy setters who are concerned that the testing financial environment, the sharp decline in house prices and persistently tight credit conditions could trigger a collapse in consumer confidence. At best this could deliver a short, sharp downturn, at worst a prolonged Japanese-style recession.
8. The sharp downturn in world commodity, food and oil prices, the lack of domestic wage pressures and weak retail demand promises a very steep decline in inflation in the year ahead. In the recent pre-Budget Report, the Treasury suggested RPI inflation could fall to minus 2.25% by September 2009. Inflation considerations will not be a constraint upon Bank of England policy action. Indeed, the threat of deflation strengthens the case for more aggressive policy ease.
9. The Government's November pre-Budget Report did feature some fiscal relaxation but it also highlighted the very poor health of public sector finances. The size of the package is considered insufficient alone to kick-start the economy. The onus for economic stimulation will fall upon monetary policy and the Bank of England.
10. The Bank will continue to ease policy and the need to drive commercial interest rates, currently underpinned by the illiquidity of the money market, to much lower levels suggests the approach will be more aggressive than might otherwise have been the case. A Bank Rate below 1% now seems a distinct possibility and short-term LIBOR rates of below 2% may result. Only when the markets return to some semblance of normality will official rates be edged higher.
11. Long-term interest rates will be the victim of conflicting forces. The threat of deep global recession should drive bond yields to yet lower levels and this will be a favourable influence upon the sterling bond markets. But the prospect of exceptionally heavy gilt-edged issuance in the next three years (totalling in excess of £100bn per annum), as the Government seeks to finance its enormous deficit, could severely limit the downside potential for yields.

12. The expected movement in interest rates is as follows:

Table 2: Medium-Term Rate Estimates (averages)

Annual Average %	Bank Rate	Money Rates		PWLB Rates*		
		3 month	1 year	5 year	20 year	50 year
2008/09	3.9	5.0	5.3	4.2	4.8	4.5
2009/10	1.0	1.6	1.8	2.4	4.8	4.7
2010/11	1.7	2.1	2.8	3.2	4.9	4.8
2011/12	2.4	2.8	3.6	4.0	5.1	4.9

* Borrowing Rates

Information provided by Butlers Consultants (updated since Cabinet: now as at February 2009).

The following debt and investment strategies are based on the above interest rate projections. The general scene is one of low returns on investment with little opportunity to restructure debt due to the premia charged by the PWLB which, simplistically speaking, increase as interest rates decrease. In the scenario that rates are expected to increase, this may mean that repaying debt is a more attractive option in the future, as this will become relatively cheaper than when the underlying rates are low. Similarly if rates are expected to rise any borrowing requirement will be taken earlier in the year.

Borrowing and Debt Strategy 2009/10 to 2011/12

13. The uncertainty over future interest rates increases the risks associated with treasury activity. As a result the Council will take a cautious approach to its treasury strategy.
14. Long-term fixed interest rates are at risk of being higher over the medium term. The Head of Financial Services, under delegated powers, will take the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above. It is likely that shorter term fixed rates may provide better opportunities.
15. With the likelihood of a steepening of the yield curve debt restructuring is likely to focus on switching from longer term fixed rates to cheaper shorter term debt, although the Head of Financial Services and treasury consultants will monitor prevailing rates for any opportunities during the year.
16. The option of postponing borrowing and running down investment balances will also be considered. This would reduce counterparty risk and hedge against the expected fall in investments returns.
17. Whilst the Capital Programme for 2009/10 provides for an in-year reduction in the underlying need for unsupported borrowing, over recent years the need has increased with £1.608M brought forward from 2006/07, £1.762M from 2007/08 and £1.811M from 2008/09. No additional actual borrowing has been entered into, however (see under paragraph 6 above). Any borrowing activity needed will take place when it is viewed most advantageous for the authority, and this will be regularly monitored by officers. The monitoring will also cover, as appropriate, continued use of the option of utilising the Council's cash balances as an alternative to immediately entering into new borrowings.

Provision for the Repayment of Debt 2009/10 to 2011/12

18. Up until 2007/08 the Council calculated the basic amount of provision, which it sets aside each year for the repayment of debt, in accordance with a prescribed formula. To this was added a further provision in respect of the financing of assets with relatively short lives, as considered prudent.
19. New arrangements were introduced from 1 April 2008. In summary:
    - the prescribed formula has been abolished and replaced by a simple requirement for Councils to make 'prudent' provision;
    - the old calculation may still be used for capital expenditure financed by unsupported borrowing (known as 'unsupported' capital expenditure) before 31 March 2008;
    - provision for supported capital expenditure can continue in the future as per the previous requirements, but
    - provision for unsupported capital expenditure after this date must either be based on the estimated life of the asset, or equal to the depreciation on the asset.

20. Financially, this has no real impact on the Council, because the changes effectively codify the full 'prudent' provision which the Council was already making, but because an element of discretion has been introduced, the Council's approach needs to be incorporated within the borrowing strategy.

21. Therefore, for 2009/10, the Council's policy for the making of provision for the repayment of debt will be as follows.

    - For all unsupported non-HRA capital expenditure prior to 01 April 2008, with the exception of that in respect of motor vehicles (less than 15 years life), by the application of the methodology detailed in the former Regulations *(i.e. 4% of the non-housing Capital Financing Requirement at the start of the year).*
    - For all such expenditure on motor vehicles prior to 01 April 2008, and for all unsupported capital expenditure after that date, equal annual amounts based on the estimated life of each individual asset so financed.

Treasury Management Prudential Indicators and Limits on Activity

22. There are four mandatory treasury Prudential Indicators. The purpose of these prudential indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. The treasury management indicators are as follows:

- Upper limits on fixed interest rate exposure – This indicator identifies a maximum limit for fixed interest rates based upon the debt position net of investments
- Upper limits on variable interest rate exposure – Similar to the previous indicator, this covers a maximum limit on variable interest rates.
- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.
- Total principal funds invested for greater than 364 days – given the current economic climate the Authority is not willing to risk investing sums for fixed terms of greater than 1 year and so this is £0.

23. The full list of prudential indicators is attached (at Appendix D for Council approval).

Performance Indicators

24. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. Examples of performance indicators often used for the treasury function are:

- Debt – Average rate movement year on year
- Investments – Internal returns above the 7 day LIBID rate

The results of these indicators will be reported in the Treasury Annual Report.