Treasury Management Strategy 2009/10 to 2011/12

Draft for Consideration by Cabinet 17 February 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 2008/09 there will be a cumulative increase in the underlying need to borrow of £3.605M (2006/07 £1.608M, 2007/08 £1.762M, 2008/09 £1.636M, 2009/10 -£1.401M – *figures subject to final budget proposals*) 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 which 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	3.9	3.8
2010/11	1.7	2.1	2.8	3.2	4.1	4.0
2011/12	2.4	2.8	3.6	4.0	4.3	4.1

* Borrowing Rates

Information provided by Butlers Consultants (January 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 investment 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 £1.636M from 2008/09 (*again, subject to Cabinet's budget proposals*). No additional actual borrowing has been entered into (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 has been added a further provision, in respect of the financing of assets with relatively short lives, as considered prudent.

19. The 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 expenditure financed by un/supported (or 'prudential') borrowing before 31 March 2008, but
    - provision for expenditure financed by un/supported borrowing 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 expenditure financed from un/supported borrowing prior to 1 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.

    - For expenditure on motor vehicles prior to 01 April 2008, and for all expenditure on motor vehicles and other short-life assets on or after that date, equal annual amounts based on the estimated life of each individual asset so financed.

Investment Strategy 2009/10 – 2011/12

22. In the current climate, the main principle governing the Council's investment criteria is the security of its investments. After this main principle the Council will ensure:

    - It maintains a policy covering the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security.

    - It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

23. The Head of Financial Services will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. It is highlighted that these criteria select which counterparties the Council will choose, rather than defining what its investments are. The ratings criteria will use the 'lowest common denominator' method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance, if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside of the lending criteria.

24. The use of the lowest common denominator method reflects the current economic climate and the Council's priority to ensure the security of its financial assets. The credit rating limits to be applied are as follows:

    - The Council will use banks, subsidiary and treasury operations of banks, Money Market funds, building societies, local authorities, the UK government and Supranational institutions (i.e. the European Central Bank (ECB) in line with the limits set out in table 3.

    - In exceptional circumstances, the Council will consider using UK banks whose ratings fall below the criteria specified in table 1 if all of the following conditions are met

        - (a) wholesale deposits in the bank are covered by a government guarantee;

        - (b) the government providing the guarantee is rated "AAA" by all three major rating agencies (Fitch, Moody's and Standard & Poors); and

        - (c) the Council's investments with the bank are limited to amounts and maturities within the terms of the stipulated guarantee.

    - The Council will also consider using banks whose ratings fall below the criteria specified in table 3 if the organisation is an Eligible Institution for the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008.

- In addition, should the authority's own bank (i.e. currently the Co-Operative Bank) fall below the criteria specified in table 3, Council will consider still using it for investment purposes, with the caveat that this will be monitored on a daily basis, with funds being moved to other counterparties meeting the criteria per table 3 at the first opportunity. Although, due to the nature of Local Government funding, there will be spikes in the balances on the current account that mean it may well exceed the £4m upper limit set in table 3 at some point (e.g. overnight), daily banking practices are already in place which aim to maintain the net current account balance at 0 +/- £100K.

25. Due to the uncertainty in the financial markets, it is acknowledged that Officers may restrict further the pool of available counterparties from the above criteria, to safer instruments and institutions. Currently this involves the use of the Debt Management Account Deposit Facility (DMADF), AAA rated Money Market Funds and institutions with higher credit ratings than those outlined in the investment strategy, or which are provided support from the Government.

26. The credit rating of counterparties will be monitored regularly. The Council receives credit rating advice from its treasury management consultants, on a daily basis, in respect of any changes in ratings, and counterparties are checked promptly. On occasion, ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Head of Financial Services. New counterparties which meet the criteria will, similarly, be added to the list. More details on the different ratings can be found in appendix B2.

27. The Authority will make deposits in both Specified and Non Specified Investments, these are defined in appendix B1. As the Council will no longer risk investing cash for greater than 1 year at present, this effectively prevents using most Non Specified products apart from the exceptions included in paragraph 24 above.

28. In addition to the credit ratings applied to institutions, the Council will only deposit with institutions in EU countries with a AAA sovereignty rating. Precedence will be given, however, to institutions listed as UK banks in the Butler's counterparty listing.

29. The exception to these sovereignty limits relates to institutions within the UK, i.e. other Local Authorities, UK based money market funds and deposits direct with the UK Government. In these cases the limits will apply as per table 3 but no sovereignty limit will apply. The Head of Financial Services retains the discretion to apply further limits where the relationship between institutions and sovereignties is ambiguous, for example UK banks who are owned by foreign institutions.

30. For the above categories of Specified and Non Specified Investments, and in accordance with the Code, the Council has developed additional criteria to set the maximum amounts which will be invested in these bodies. The criteria, using the lowest common denominator approach (see paragraph 24 above) are set out below.

Table 3: Counterparty criteria and investment limits.

	Minimum across all three ratings			Money Limit	Time Limit
	Fitch	Moody's	Standard & Poors		
Upper Limit[1]	F1+/AA-	P-1/AA3	A-1/AA-	£4M	N/A - Instant Access Only
Middle Limit[2]	F1/A-	P-1/A3	A-1/A-	£2M	1 Year
Other Institutions[3]	N/A	N/A	N/A	£4M	1 Year
Money Market fund[4]	AAA	AAA	AAA	£4M	N/A - Instant Access Only
DMADF deposit[5]	N/A	N/A	N/A	£10M	1 Year
Sovereign rating to apply to all foreign counterparties except UK investments[6]	AAA	AAA	AAA	N/A	N/A

Note that the Time Limit starts on the placing of the investment and not its inception date

1 & 2 The Upper and Middle Limits apply to appropriately rated banks and building societies.
3 The Other Institutions limit applies to other local authorities and supranational institutions (i.e. ECB).
4 Sterling, constant net asset value funds only, sovereignty limits apply to domicile of host institution.
5 The DMADF facility is direct with the UK government, it is extremely low risk and hence the higher limit.
6 UK investments are defined as those listed under UK banks or building societies in the Butler's counterparty listing.

31. In the normal course of the Authority's cash flow operations it is expected that both Specified and Non-specified Investments will be utilised for the control of liquidity as both categories allow for short term investments. The Council will maintain a minimum £2M of investments in Specified Investments provided that the cashflow allows for this.

32. To control the geographical risk, no more than £4M will be invested in any one country, with the exception of institutions listed as UK banks on the counterparty listings supplied by Butlers.

33. The use of longer term instruments (greater than one year from inception to repayment) will not be used.

34. Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of the current 1.0% Bank Rate reducing during 2009/10. This means that the average rate receivable on the Council's investments will be significantly below that for 2008/09, which was running at an average of 5.1% over the year to the end of December 2008.

35. The criteria for choosing counterparties set out above provide a sound approach to investment in current market circumstances. Whilst formal Member approval is required for the base criteria above, under exceptional market conditions the Head of Financial Services will temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out above.

36. Examples of these restrictions would be the greater use of the Debt Management Account Deposit Facility (DMADF) – the Government body which accepts local authority deposits, but at very low rates of interest.

Treasury Management Prudential Indicators and Limits on Activity

37. 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 full list of Prudential Indicators is included elsewhere on the agenda, but 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.

38. Council will be requested to approve the Prudential Indicators, as updated in line with final budget proposals, at its meeting on 04 March 2009.

Table 4: Prudential Indicators

	2009/10		**2010/11**		**2011/12**	
Interest Rate Exposures						
	Upper		**Upper**		**Upper**	
	£'000		**£'000**		**£'000**	
Limits on exposure to fixed interest rates	£40m		£40m		£40m	
Limits on exposure to variable interest rates	£14m		£14m		£14m	
Maturity Structure of fixed interest rate borrowing						
	Lower	**Upper**	**Lower**	**Upper**	**Lower**	**Upper**
Under 12 months	0%	35%	0%	35%	0%	35%
12 months to 2 years	0%	20%	0%	20%	0%	20%
2 years to 5 years	0%	20%	0%	20%	0%	20%
5 years to 10 years	0%	20%	0%	20%	0%	20%
10 years and above	60%	100%	60%	100%	60%	100%
Maximum principal sums invested > 364 days						
Principal sums invested, in 2008/09, for periods of greater than 364 days, to mature after the end of each financial year	£0M		£0M		£0M	

Performance Indicators

39. 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.