ANNEX 1

TREASURY MANAGEMENT STRATEGY STATEMENT and ANNUAL INVESTMENT STRATEGY 2006/07

1 Introduction

1.1 The Local Government Act 2003 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 the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (included as paragraph 10); 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 suggested strategy for 2006/07 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 adviser. The strategy covers:

- treasury limits in force which will limit the treasury risk and activities of the Council;
- prudential indicators
- the current treasury position;
- the borrowing requirement;
- prospects for interest rates;
- the borrowing strategy;
- the investment strategy; and
- any extraordinary treasury issues.

2 Treasury Limits for 2006/07 to 2008/09

2.1 It is a statutory duty under S.3 of the Local Government Act 2003 and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the "Affordable Borrowing Limit". In England and Wales the authorised limit represents the legislative limit specified in section 3 of the Local Government Act 2003.

2.2 The Council must have regard to the Prudential Code when setting the 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 and council rent levels is ‘acceptable’.

2.3 Whilst termed an “Affordable Borrowing Limit”, the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.

3 Prudential Indicators for 2006/07 – 2008/09

3.1 The prudential indicators that are relevant for the purposes of setting an integrated treasury management strategy are shown at **[APPENDIX 1]** in respect of Treasury Management. These and those in respect of Capital and the Affordable Borrowing Limit are set out within the Budget Setting Report 2006/07 that Members will consider elsewhere on the agenda for this meeting.

3.2 The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. This was adopted on 30 September 2003 by the full Council.

4 Current Portfolio Position

4.1 The Council’s treasury portfolio position at 31 December 2005 comprised:

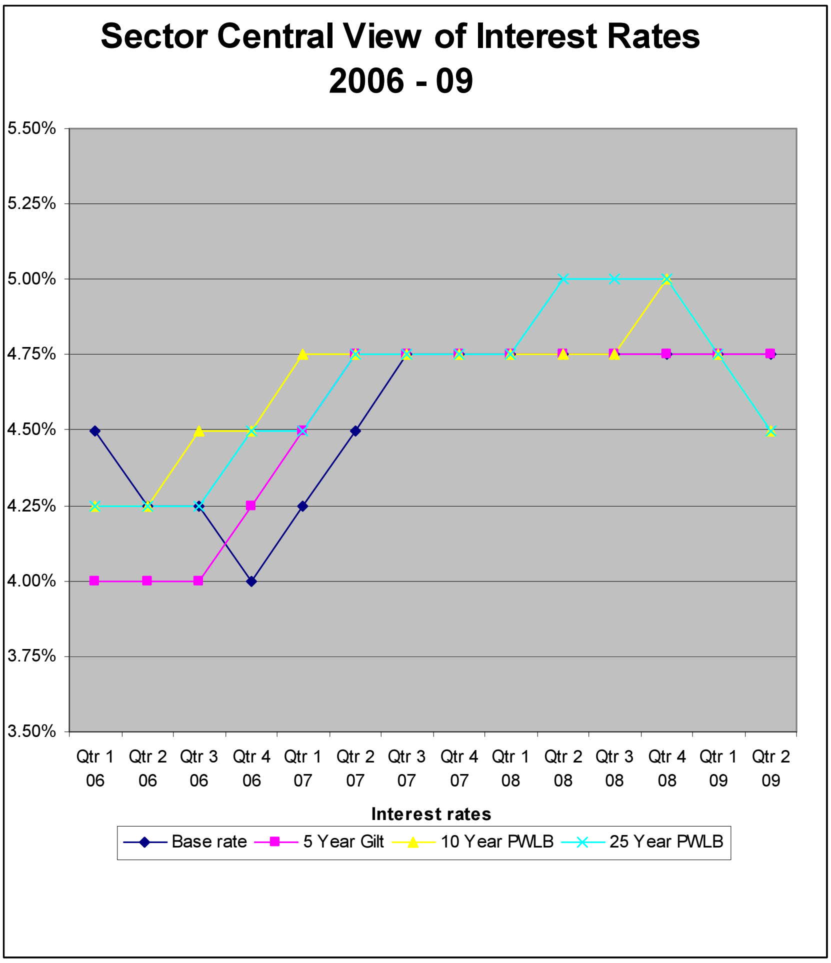
	Principal £’m	Averaged Rate	Duration - Years
Externally managed investments (with Fund Manager)	£34.96	4.56%	0.46
Internally managed investments	£4.88	4.47%	0.003
Total Investments	**£39.84**	**4.55%**	**0.404**

5 Borrowing Requirement

5.1 Other than for cash flow purposes and then within the limits set out at **[APPENDIX 1]** borrowing will not be necessary.

6 Prospects for Interest Rates

6.1 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 2]** 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 graph represents the Sector central view of interest rates.



6.2 The risk to the above view is to the downside in as much as the cuts in rates could occur earlier than our forecast suggests, although this will not necessarily affect the timing of the first upward move in Q1 2007.

7 Economic background

The UK

- GDP growth weakened from 3.2% in 2004 to 1.7% in 2005 under the impact of monetary and fiscal tightening and the oil price shock depressing household spending. Growth is expected to recover weakly to about 2.0% in 2006 and then return to the long term trend rate of 2.5% in 2007. Other relevant indicators are as follows:

- House price inflation has fallen to low levels and may now stabilise.
- Inflation forecast to stay around target despite hike in oil prices. MPC on alert for pipeline cost pressures, primarily from oil price increases, feeding through into output prices and then into retail prices.
- Public sector deficit to decline steadily over next few years as the Government cuts back on the rate of growth of its expenditure.

International

- Boom in world commodity prices driven by strong growth in China and India; potential for further increases in prices but supply side increases and improvements in technology are likely to reduce prices in the medium term.
- Inability of oil producers to spend their huge cash surpluses and reluctance of Asian economies to run current account deficits will suppress world demand and dampen world growth.
- US - Fed nearing the end of its phase of measured rate rising. Fed rate may now peak at 4.5%.
- US GDP growth expected to weaken from 4.2% 2004 to 3.5% 2005 and 3.0% 2006.
- ECB had held repo rate at 2.00% since June 2003; increase in December to 2.25% and further increases expected as the economic outlook has improved.
- Eurozone GDP growth expected to rise weakly and to continue to under perform the UK and US economies.

8 Interest Rate Forecast

8.1 Sector expect the base rate to fall to 4.25% by the end of 2006 before rising to 4.75% towards the end of 2007 and thereafter remaining at that level until 2009. Longer term rates are expected to move in a broadly similar way.

8.2 The expectations of our Cash Fund Manager are a little less pessimistic. They predict that the base rate will remain at 4.5%, before rising to 4.75% during the first quarter of 2007 and it is these figures that are reflected in these strategies and our Medium Term Financial Strategy.

9 Borrowing Strategy

9.1 It is anticipated that there will not be a need for capital borrowings during 2006/07.

10 ANNUAL INVESTMENT STRATEGY

Investment Principles

10.1 Council will have regard to the ODPM's Guidance on Local Government Investments ("the Guidance") issued in March 2004 and CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities are: -

- the security of capital and
- the liquidity of its investments.

10.2 The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

10.3 The borrowing of monies purely to invest in order to make a return is unlawful and this Council will not engage in such activity.

10.4 Investment instruments identified for use in the financial year 2006/07 are listed at **[APPENDICES 3 and 4]** under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices.

Specified Investments

10.5 A specified investment can be defined as "a highly secure and highly liquid investment that is made in sterling for a period of no more than one year". Such short-term investments made with the UK Government or a local authority or parish council will automatically count as specified investments.

10.6 In addition, short-term sterling investments with bodies or investment schemes with "high credit ratings" will count as specified investments provided these are identified within the Annual Investment Strategy.

10.7 The specified investments that the Council's treasury advisers and the Director of Finance consider appropriate for 2006/07 are set out at **[APPENDIX 3]** to this document.

Non-specified Investments

10.8 Non-specified investments can be defined as all other investments and, because of the greater potential risk it is considered necessary to deal with these in more detail within the Annual Investment Strategy. That detail shall include the types of investments that may be used, the proportion of overall funds that may be committed to each type and also guidelines on when professional advice should be sought.

10.9 The non-specified investments that the Council's treasury advisers and the Director of Finance consider appropriate for 2006/07 are set out at **[APPENDIX 4]** to this document.

10.10 The appendix also sets out :

- the advantages and associated risk of investments under the "non specified" category;
- the upper limit to be invested in each 'non-specified' category; and
- those instruments that would best be used by the Council's external cash fund manager(s) and when consultation with the Council's treasury adviser is necessary.

Liquidity of Investments

10.11 Based on its cash flow forecasts, the Council anticipates its fund balances in 2006/07 to range between £25m and £35m. This includes potential capital receipts of £0.04m from the redemption of mortgages.

10.12 Giving due consideration to the Council's level of balances over the next six years, the need for liquidity, its spending commitments and provision for contingencies, it is recommended that up to 70% may be held by the Council's fund manager in 'non specified' investments during the year.

10.13 **[APPENDICES 3 and 4]** to this document sets out the maximum periods for which funds may be prudently committed in each asset category.

Security of Capital: Compliance and Credit Ratings

10.14 The Council's external fund manager will comply with the Annual Investment Strategy. The agreement between the Council and the fund manager additionally stipulate guidelines and duration and other limits in order to contain and control risk.

10.15 The Council uses Fitch ratings to derive its counterparty criteria. Where a counterparty does not have a Fitch rating, the equivalent Moody's (or other rating agency if applicable) rating will be used. All credit ratings will be monitored on a continuous basis via changes in Fitch ratings notified by way of Sector creditworthiness service. If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

Investments Defined as Capital Expenditure

10.16 The acquisition of share capital or loan capital in any body corporate is defined as capital expenditure under Regulation 25(1)(d) of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003. Such investments would have to be funded out of capital or revenue resources and would be classified as 'non-specified investments'.

10.17 A loan or grant or financial assistance by this Council to another body for capital expenditure by that body would also be treated as capital expenditure.

10.18 For the purposes of this Investment Strategy, the Council will not use or allow its external fund managers to make any investment that would be deemed capital expenditure.

Provisions for Credit-related losses

10.19 If any of the Council's investments appeared at risk of loss due to default (i.e. this is 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.

Investment Strategy to be followed in-house

10.20 The Council's in-house managed funds are mainly cash flow derived and there is a presumption that any cash flow surpluses available for longer than three months will be placed with the external fund manager. Investments of more than three months are permissible with the specific approval of the Director of Finance. Investments will accordingly be made with reference to the core balance and cash flow requirements and the outlook for shorter-term interest rates (i.e. rates for investments up to 12 months).

10.21 The Council's Treasury Adviser, Sector, is forecasting the base rate to be 4.25% in Q2 2006, 4.0% in Q4 and 4.25% in Q1 of 2007. The Council will accordingly seek to lock in longer period investments at higher rates before this fall starts for some element of the core cash flow balance. Some investments should be aimed to mature during Q1 2007 when the interest rate cycle turns up and the market yield curve should have turned positive. Thereby locking into higher yielding investments. Business accounts and short-dated deposits (1-3 months) should continue to be used to benefit from the compounding of interest at potentially higher rates.

10.22 It is not considered necessary to set trigger rates for lending of one year and beyond at this time. In the unlikely event that such rates are needed advice will be sought from Sector before a recommendation is made to Council.

Investment Strategy to be followed by the external Cash Fund Manager

10.23 Investec Investment Management Ltd will manage a core of around £26m of the Council's funds on a discretionary basis during 2006/07. The fund manager will be contractually required to comply with this Strategy.

10.24 The Council will discuss with its external fund manager instruments that they consider may be prudently used to meet the Council's investment objectives. The Council will evaluate the risk-reward characteristics of asset categories to decide whether to permit the manager to use instruments that comply with the Guidance.

10.25 The management agreement(s) between the Council and the manager(s) formally document the terms for management, including guidelines and instruments they can use within pre-determined limits.

10.26 The central forecast of Investec is that that the UK base rate will remain at 4.5% throughout 2006 in response to :

- The easing of inflationary concerns; and
- Growth in the economy remaining below trend.

10.27 Risks to this forecast in 2006 are skewed towards lower rates despite the potential impact of rising energy prices on wage settlements. Rates are then expected to start to rise in early 2007. The Strategy for the coming year will, therefore, allow for a shortening of the portfolio duration in the summer in order to take advantage of the forthcoming rising interest rate environment. In addition, value to the portfolio is expected to be added via tactical exposure to gilts and to longer dated CDs upon any economic setbacks. These measures are expected to generate a return of 4.75% which figure accords with rate of return used for the Medium Term Financial Strategy.

11 End of year Investment Report

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

(This is an extract – a full version can be found on the agenda for Cabinet 7 February 2006)