ANNEX 1

TREASURY MANAGEMENT STRATEGY STATEMENT AND INVESTMENT STRATEGY FOR 2007/08

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 9); 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 2007/08 in respect of the following aspects of the treasury management function is based upon the Treasury Officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor. The strategy covers:

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

2 TREASURY LIMITS FOR 2007/08 TO 2009/10

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.

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3 PRUDENTIAL INDICATORS FOR 2007/08 – 2009/10

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 for 2007/08 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 2006 comprised:

	Principal £'m	**Running Yield @ 31/12**	**Duration - Years**
Externally managed investments (with Fund Manager)	£ 24.95	% 5.7	0.51
Internally managed investments	13.88	5.1	0.25
Total Investments	**£38.83**	**5.5%**	**0.41**

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 table represents the Sector central view of interest rates **at the time of writing this report.**

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	Q/E1 2007	Q/E2 2007	Q/E3 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	Q/E1 2010	Q/E2 2010	Q/E3 2010
Bank rate	5.50%	5.50%	5.50%	5.25%	5.00%	4.75%	4.75%	4.75%	4.75%	4.75%	5.00%	5.00%	5.00%	5.00%	5.00%
5yr PWLB rate	5.25%	5.25%	5.00%	4.75%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
10yr PWLB rate	5.00%	5.00%	4.75%	4.75%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
25yr PWLB rate	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
50yr PWLB rate	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%

6.2 Sector's current interest rate view, at the time of writing this report, is that Bank Rate will: -

- peak at 5.50% in quarter 1 2007;
- fall to 5.25% in Q4 2007 and then to 5.00% in Q1 2008; and then
- fall to 4.75% in Q2 2008 before rising back to 5.00% in Q3 2009.

6.3 Once inflation is back under control, Bank Rate will switch to a falling trend in late 2007 to counter above negative effects on the economy and growth.

7 <u>ECONOMIC BACKGROUND</u>

THE UK

- GDP: the UK is on the upswing of the economic cycle from a low point reached in June 2005. Robust growth is expected to continue for a little longer but a modest cooling is expected in 2007 (2006 2.5%, 2007 2.0%) and to continue at below the trend rate of 2.5% thereafter.
- Recovery in consumer spending and retail sales has underpinned this upswing in GDP.
- The housing market has proved more robust than expected; house price inflation over 8% p.a.
- Higher than expected immigration from Eastern Europe has strengthened growth and dampened wage inflation.
- The MPC's decision to raise Bank Rate in November 2006 and January 2007 were needed to bring CPI inflation down to the 2% target level two years ahead. The MPC has been concerned that short term price increases (CPI has been significantly above target since June 2006) could feed through into wage settlements in the current pay round and anchor inflation expectations at a higher level.

- Household income growth to recover in 2007 as inflation falls and pay rises. But extra income likely to go into a recovery of the savings rate, pension saving and servicing debt costs (as rates rise) rather than consumer expenditure.
- Public sector real increase in expenditure per annum to weaken to 2.5% over the next few years from 3% average over 2000-2005.
- The three increases in Bank Rate in August and November 2006 and then January 2007, are expected to dampen the housing market and increases in unsecured borrowing although one more increase in Bank Rate is forecast.
- World slowdown in growth in 2007 will dampen UK exports.

International

- The US, UK and EU economies have all been on the upswing of the economic cycle in 2005 and 2006 and so have been raising interest rates in order to cool their economies and to counter inflationary pressures stimulated by high oil, gas and electricity prices which could feed through into increases in wage inflation, producer prices etc.
- The US is ahead of the UK and EU in the business cycle and it looks as if the Fed. rate has probably already peaked at 5.25% whereas there is an expectation in the financial markets of further increases in the EU and UK.
- The major feature of the US economy is a still steepening downturn in the housing market which is likely to drag consumer spending, and so the wider economy, down with it (e.g. house building, employment etc.). Falling house prices will also undermine household wealth and so lead to an increase in savings (which fell while house prices were rising healthily) and so conversely will lead to a fall in consumer expenditure.
- The Fed. may be reluctant and tardy to respond to the aforementioned downturn in the economy if inflationary pressures remain stubbornly high. This could exacerbate the downturn both in the US and the world economies.
- EU growth picked up strongly in the first half of 2006 and is expected to remain healthy in the second half. Growth to slow moderately in 2007 due to weaker US and global demand.
- Despite sharply increased energy prices, disinflationary pressures from falls in prices of manufactured goods from China and India have helped to keep headline inflation in the advanced economies to an average of around 3% and will fall as the energy effects go into reverse.

8 BORROWING STRATEGY

8.1 It is anticipated that there will not be a need for capital borrowings during 2007/08.

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9 ANNUAL INVESTMENT STRATEGY

9.1 Investment Principles

9.1.1 Council will have regard to DCLG's (formerly the ODPM) 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.

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

9.1.3 Investment instruments identified for use in the financial year 2007/08 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.

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

9.2 Specified Investments

9.2.1 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.

9.2.2 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.

9.2.3 The specified investments that accord with advice provided by the Council's treasury advisers and that the Director of Finance consider appropriate for 2007/08 are set out at **[APPENDIX 3]** to this document.

9.3 Non-specified Investments

9.3.1 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.

9.3.2 The non-specified investments that the Council's treasury advisers and the Director of Finance consider appropriate for 2007/08 are set out at **[APPENDIX 4]** to this document.

9.3.3 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 advisor is necessary.

9.4 Liquidity of Investments

9.4.1 Based on our cash flow forecasts, it is anticipated that fund balances in 2007/08 will range between £25m and £35m.

9.4.2 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 75% may be held in 'non specified' investments during the year.

9.4.3 The maximum periods for which funds may be prudently committed in each asset category are set out at **[APPENDICES 3 and 4]** to this document.

9.5 Security of Capital: Compliance and Credit Ratings

9.5.1 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.

9.5.2 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.

9.6 Investments Defined as Capital Expenditure

9.6.1 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'.

9.6.2 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.

9.6.3 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.

9.7 Provisions for Credit-related losses

9.7.1 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.

9.8 Investment Strategy to be followed in-house

9.8.1 The Council's in-house managed funds will be invested having regard to the core balance and cash flow requirements in those markets, instruments and limits set out within the Approved Specified and Approved Non-specified Investment appendices.

9.8.2 The in-house team is expected to manage a mix of cash flow derived and longer term investments amounting to between £12m and £25m in response to the changes made to the Investment Strategy in September 2006 and re-iterated in the Strategy for 2007/08. The upper limit could increase to £35m if a decision was made to internally manage all of our funds.

9.8.3 Sector is, at the time of writing, forecasting Bank Rate to rise to 5.5% before falling to 5.0% in Q1 2008, and then 4.75% in Q2 2008. There after the Bank Rate is expected to rise to 5.0% in Q3 2009 and remain at that level for the foreseeable future. It is, therefore, proposed to lock in a proportion of core/longer period investments at higher rates before this fall starts.

9.8.4 Business accounts and short-dated deposits (1-3 months) will continue to be used to benefit from the compounding of interest at potentially higher rates.

9.8.5 Trigger rates for lending of one year or more will be obtained from and kept updated via the Council's Treasury Adviser. Such investments must be specifically approved within the provisions of the Corporate Governance arrangements set out in the Treasury Management Practices that were approved by Council on 12 December 2006.

9.8.6 The trigger rates for lending identified by Sector and proposed for adoption are:

- 5.60% for 1-year lending
- 5.60% for 2 year lending
- 5.60% for 3 year lending
- 5.50% for 4 year lending
- 5.50% for 5 year

The ‘trigger points’ will be kept under review and discussed with Sector so that investments can be made at the appropriate time.

9.8.7 **Investment Strategy to be followed by the external Fund Manager(s)**

9.8.8 The fund manager(s) appointed to manage part or all of the Council’s core balances will be contractually required to comply with this Strategy and will additionally be bound by the terms of the fund management agreement. The latter will record in addition to the precise terms of management, detailed guidelines as to the instruments they can use and any pre-determined limits.

9.8.9 The core balance to be discretionarily managed externally during 2007/08 is expected to be between £12m and £26m. During the year discussions will take place with our Treasury Adviser and the external fund manager to determine which instruments may be most suited to prudently meeting the Council’s investment objectives.

9.8.10 The central forecast of our fund manager is that the case for rates having peaked at the new level of 5.25% is equally balanced to the likelihood of a further rise to 5.50% in the near future.

9.8.11 As there was no record of an explicit discussion to raise (or lower) rates in the latest MPC minutes our fund manager continues to believe the peak in rates is in place. However, the risks are still skewed to the upside, based on the underlying strength in the housing market and the possibility that higher inflation (RPI 4.0%) could filter through into wage negotiations, although hard evidence of this has yet been seen.

9.8.12 The central case forecast for 2007/08 based upon the above strategy is 5.75%.

9.9 End of year Investment Report

9.9.1 At the end of the financial year, the Council will receive a report on the outcomes of investment activity as part of the Annual Treasury Report.