**ANNEX 1**

# TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2008/09

## 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 the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance issued subsequent to the Act) (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 2008/09 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.

**1.4** 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 charges to revenue from:

- 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 LIMITS FOR 2008/09 TO 2010/11

**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 Authorised 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 2008/09 – 2010/11

**3.1** The prudential indicators that are relevant for the purposes of setting an integrated treasury management strategy are shown at **[APPENDIX 1]**. These and those in respect of Capital and the Affordable Borrowing Limit are set out within the Budget Setting Report for 2008/09 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 2007 comprised:

| | Principal £’m | Running Yield @ 31/12 | Duration - Years |
|---|---|---|---|
| Externally managed core investments | £15.85 | 6.1% | 0.37 |
| Internally managed core investments | £12.00 | 5.86% | 1.28 |
| Internally managed cash flow investments | £10.76 | 5.93% | 0.11 |
| **Total Investments** | **£38.61** | **5.98%** | **0.58** |

## 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 (Bank Rate) and longer fixed interest rates. The following table gives the Sector central view:

# TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2008/09

| | 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% |
| 5yr PWLB rate | 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 rate | 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% |
| 25yr PWLB rate | 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% |
| 50yr PWLB rate | 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% |

**6.2** Sector's current interest rate view is that Bank Rate: -

- started on a downward trend from 5.75% to 5.50% in December 2007;
- to be followed by further cuts in Q1 2008 to 5.25% and to 5.00% in Q2 2008; and
- then unchanged for the following two years.

**6.3** There is downside risk to this forecast if inflation concerns subside and so open the way for the MPC to be able to make further cuts in Bank Rate.

## 7 ECONOMIC BACKGROUND

### 7.1 International

- The US, UK and EU economies have all been on the upswing of the economic cycle during 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 both 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 downturn 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 4.0% by April 2008 to try to stimulate the economy and to ameliorate the extent of the downturn. However, the speed and extent of these cuts will be inhibited by inflationary pressures arising from oil prices, the falling dollar increasing the costs of imports, etc. The US could well be heading into stagflation in 2008 – a combination of inflation and a static economy (but the economy could even tip into recession if the housing downturn becomes severe enough).
- The major feature of the US economy is a steepening downturn in the housing market which is being undermined by an excess stock of unsold houses stoked by

defaulting sub prime borrowers pushed into forced sales. 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. Petrol prices have trebled since 2003 and, with similar increases in the price of home heating oil, this will also depress consumer spending with knock on effects on house building, employment etc.

- The downturn in economic growth in the US in 2008 will depress world growth, (especially in the western economies), which will also suffer directly under the impact of high oil prices. However strong growth in China and India will partially counteract some of this negative pressure.
- EU growth has been strong during 2006 and 2007 but will be caught by the general downturn in world growth in 2008.

**7.2 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.
- Higher than expected immigration from Eastern Europe has underpinned strong growth and dampened wage inflation.
- House prices started on the downswing in Q3 2007 and this is expected to continue into 2008.
- The combination of increases in Bank Rate and hence mortgage rates, short term mortgage fixes expiring and being renewed at higher rates, food prices rising at their fastest rate since 1993 and increases in petrol prices, have all put consumer spending power under major pressure.
- 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.
- Government expenditure will be held under a tight reign for the next few years, undermining one of the main props of strong growth during this decade.
- The MPC is very concerned at the build up of inflationary pressures especially the rise in the oil price to $90 – 100 per barrel (was $30 in 2003) and the consequent likely knock on effects on general prices. The prices of UK manufactured goods have risen at the fastest rate in 16 years in November 2007 – 4.5%. Food prices have also risen at their fastest rate for fourteen years (6.6% annual increase) driven by strong demand from China and India. Consequently, the MPC is going to be much more cautious about cutting rates compared to the Fed. in the face of these very visible inflationary pressures. In addition, UK growth was still exceptionally strong in Q3, as has also been the growth in the money supply. The downward trend in Bank Rate is now expected to be faster than at first thought after the initial cut in December 2007 to 5.50% in view of the MPC minutes which showed a unanimous MPC vote for a cut and the consideration given to a half per cent cut. This demonstrated how concerned the MPC is at the potential impact of the credit crunch on the economies of the western world. However, the MPC's room for cutting rates is currently limited by concerns over inflationary pressures. However, if those pressures subside, then there is further downward risk to the Sector forecast which currently only allows for 0.25% cuts in Q1 and Q2 2008 before Bank Rate stabilises at 5.0% for the next two years.

# TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2008/09

## 8 BORROWING STRATEGY

**8.1** It is expected that there will not be a need for capital borrowing during 2008/09.

## 9 ANNUAL INVESTMENT STRATEGY

### 9.1 Investment Principles

9.1.1 The Council will have regard to the DCLG'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.

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 2008/09 are listed at **[APPENDICES 3 and 4]** under the "Specified" and "Non-Specified" investment categories. Counter party limits will conform to those set out in the Council's Treasury Management Practices (TMP's).

9.1.4 The borrowing of monies purely to invest or on-lend and 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 2008/09 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 2008/09 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 2008/09 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 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 counter party 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**

**In-house core funds**

9.8.1 The Council's in-house team is expected to manage between £12m and £25m of core funds, the latter figure being dependent on what further funds are drawn in-house for management. Investments will comply with the instruments and limits set out within the Approved Specified and Approved Non-specified Investment appendices.

9.8.2 Sector is currently forecasting that the Bank Rate has now started on a downward trend from 5.75% to 5.50% in December 2007. This will continue with further cuts forecast to 5.25% in Q1 2008 and again to 5.00% in Q2 2008. It is then expected to remain unchanged for the next two years.

9.8.3 In response to this scenario, business accounts and short-dated deposits (1-3 months) will be used to benefit from the compounding of interest at potentially higher rates and to generate an overall rate of return of 5.5%.

9.8.4 If the risks from higher inflation outweigh those from a contraction in the economy then longer dated investments will be considered subject to the following minimum investment levels for investments:

- 5.45% for 1-year lending;
- 5.55% for 2 year lending;
- 5.55% for 3 year lending;
- 5.65% for 4 year lending; and
- 5.65% for 5 year lending.

9.8.5 The minimum investment levels will be kept under review and discussed with Sector so that investments can be made at the appropriate time.

**Externally managed core funds**

9.8.6 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.

9.8.7 The core balance to be discretionarily managed externally during 2008/09 is expected to be between £0m and £12m. The former figure depending on the extent to which further funds are drawn in-house for management in response to failings in performance. 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 and at what point any further withdrawals should be made.

9.8.8 The best forecast of our fund manager is for a return of 5.50% in 2008/09. This rate of return is considered achievable, based upon a scenario where by the credit crunch continues to ease and the risks from stagnation and inflation continue to be marginally in favour of the former.

**Internally managed cash flow funds**

9.8.9 The cash flow balance managed internally is expected to range from £0m to £10m, the higher figure generally applying immediately prior to precept dates.

9.8.10 In response to a climate of falling interest rates it is expected that business accounts, money market funds and short-dated deposits (1-3 months) will continue to be used to benefit from the compounding of interest at potentially higher rates.

9.8.11 The expected return from cash flow investments for 2008/09 is expected to be 5%.

**9.9 End of year investment report**

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