

TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY FOR 2009/10

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 2009/10 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;
 - treasury management prudential indicators;
 - the current treasury position;
 - the borrowing requirement;
 - prospects for interest rates;
 - the borrowing strategy;
 - the investment strategy; and
 - the position re Landsbanki.
- 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 2009/10 TO 2011/12

- 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

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sustainable limits and, in particular, that the impact upon its future council tax 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 2009/10 – 2011/12

- 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 2009/10 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 2008 comprised:

	Principal £'m	Running Yield @ 31/12	Duration - Years
Externally managed core investments	£13.80	2.91%	0.64
Internally managed core investments	£12.00	6.16%	1.49
Internally managed cash flow investments	£14.24	4.39%	0.05
Total Investments	£40.04	4.40%	0.73

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:

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	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	Q/E2 2011	Q/E3 2011	Q/E4 2011	Q/E1 2012
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.75%	2.50%	3.25%	3.75%	4.00%
5yr PWLB rate	2.50%	2.25%	2.15%	2.15%	2.15%	2.45%	2.80%	3.15%	3.65%	3.95%	4.20%	4.45%	4.60%
10yr PWLB rate	3.10%	2.75%	2.55%	2.55%	2.55%	2.85%	3.25%	3.65%	4.15%	4.40%	4.70%	4.75%	4.85%
25yr PWLB rate	4.00%	3.95%	3.95%	3.95%	4.00%	4.15%	4.35%	4.45%	4.60%	4.85%	4.95%	5.00%	5.05%
50yr PWLB rate	3.85%	3.80%	3.80%	3.80%	3.85%	3.90%	4.00%	4.25%	4.40%	4.70%	4.80%	4.95%	5.00%

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

- Will fall from current levels because of the intensifying global recession.
- Starting 2009 at 2.00%, Bank Rate is forecast to fall to 0.5% in Q1 2009.
- It is then expected to remain there until starting to rise gently up from Q2 2010 till it reaches 4.0% in Q1 2012.
- There is downside risk to these forecasts if the recession proves to be deeper and more prolonged than currently expected.

7 ECONOMIC BACKGROUND

7.1 Introduction

The sub prime crisis of early 2008 was supplanted by the banking crisis of autumn 2008. The world banking system came near to collapse and governments around the world were forced to recapitalise and rescue their major banks. The resulting dearth of lending from banks anxious to preserve capital led to economic forecasts being sharply reduced and recession priced into markets. This in turn led to sharp falls in oil and other commodity prices with the result that inflation, which in the UK was running at over 5%, became yesterday's story and recession fears drove interest rate sentiment and policy. A co-ordinated global interest rate cut of 50bp took place on 8th October 2008. Forecasts in the UK were for further sharp cuts in interest rates as recession hove into view.

7.2 International

- Early in 2008 the US economy was being badly affected by the housing market slump. Interest rates were at 2% and inflation was being dragged higher by the inexorable rise in commodity prices. The ECB was very concerned about rising inflation and less about the state of the economy.
- The second quarter of 2008/9 was torn between inflation worries on the one hand, with oil rising towards \$150 per barrel, and the deteriorating economic outlook on the other.
- In the second and third quarters of the year the financial crisis erupted and escalated as the world became aware of the extent of the sub-prime fiasco and the impact it was having on institutions that had invested in these issues.

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- In September Fannie Mae/Freddie Mac (the mortgage banks) and AIG, the insurance giant, had to be bailed out by the US Federal Government.
- Then in mid September, Lehman Bros., the investment bank, was allowed to fail. This triggered a domino effect with other banks and financial institutions having to be rescued or supported by governments around the world.
- After the collapse into receivership of the Icelandic banks in early October, other countries then started to feel the strain and a number had to approach the IMF for support.
- Eventually even the Asian 'Tiger' economies were affected, including India and China, and it became clear that the crisis had become a global one and no country was insulated from it.
- The financial crisis had therefore precipitated an economic crisis and there was a co-ordinated global interest rate cut with the Fed, ECB and MPC all cutting rates by 50bp on 8th October. The Fed subsequently cut rates again by 50bp to 1% on 29th October and again on 16 December to a band of 0.0% to 0.25% in an attempt to stave off the oncoming recession. Inflation was yesterday's problem.
- On 4th November the USA elected Barack Obama as President with little immediate financial impact.
- The ECB reduced rates again on 6th November by 50bp, by its biggest ever cut of 75bp on 4 December to reach 2.5% and then by a further 0.5% to reach 2% on 15 January 2009.

7.3 UK

- GDP: growth was already slowing in 2008 from 2007 before the full impact of the credit crunch was felt. Earlier in 2008 GDP was 2.3% whereas in the autumn the figure fell back to -0.3% and was then expected to continue to be negative going into 2009.
- Wage inflation remained relatively subdued as the Government kept a firm lid on public sector pay. Private sector wage growth was kept in check by the slowing economy.
- Growth slowed across the economy and unemployment rose throughout the year with forecasts of 2 million unemployed by the end of the financial year and continuing to increase thereafter through 2010.
- Notwithstanding the pressures on household finances consumer spending still continued at a reasonable clip although the trend was slowing as the year progressed.
- Bank lending came to a virtual standstill in the autumn as the credit crunch tightened its grip and various banks internationally had to be rescued, or supported, by their governments.
- The Government and Bank of England supplied massive amounts of liquidity to the banking market in an attempt to reignite longer interbank lending.
- The Government took action in September to either supply finance itself to recapitalise some of the major clearing banks or to require the others to strengthen their capital ratios by their own capital raising efforts. This was so that these banks would be seen to have sufficient reserves to last through the coming recession with its inevitable increase in bad loans etc.
- The housing market also came to a virtual standstill as lenders demanded larger deposits and higher fees. House sales and prices both dropped sharply.

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- Government finances deteriorated as income from taxation dropped as the economy slowed and the cost of the bailout of the banks was added to the deficit.
- U.K. equity prices declined sharply in the 3rd and 4th quarters as the impending recession was priced into the markets. Prices hit five year lows and volatility was extremely high.
- The story of 2008 has been the credit crunch, the banking crisis and the change in economic outlook from slow growth to outright recession. After the initial concerns about the impact of the credit crunch in the earlier part of 2008 it appeared as though the storm had been weathered. The MPC had been very concerned about CPI inflation, which had been rising sharply on the back of higher commodity and food prices. Bank Rate reached a peak of 5.75% in July 2007 after which cuts of 0.25% occurred in December 2007 and February and April 2008 before the major cuts in the autumn. The economic data had been indicating a slowing economy for some while but it was not sufficiently weak to force the MPC into another cut. It was the strength of the banking crisis, pre-empted by the collapse of Lehmans in New York that eventually drove the MPC to cut interest rates by 50bp on October 8th in concert with the Federal Reserve, the ECB and other central banks. It was then appreciated that the economic downturn would be much more severe than previously thought and interest rates were subsequently slashed by 150bps on 6 November, 100bps on 4 December and 50 bps on 8 January 2009.
- The LIBOR spread over Bank Rate has also been a feature, and a concern, of 2008/9. Because of the credit fears and the reluctance of lenders to place cash for long periods 3 month LIBOR (this is the London Inter Bank Offer Rate – the rate at which banks will lend to one another) has been substantially higher than Bank Rate. This has meant that the MPC's power over monetary policy has been eroded by the widening of this spread between LIBOR and Bank Rate and it has therefore had a limited ability to bring relief to hard pressed borrowers through lower interest rates. However, the power of the Government over the semi nationalised clearing banks had considerable impact in enforcing pro rata reductions to the 150 bps Bank Rate cut in November on some borrowing rates.
- The Government has abandoned its 'golden rule'. The pre Budget Report on 14 November revealed the Government's plans for a huge increase in Government borrowing over coming years as a result of falling tax revenues and also due to tax cuts and increases in Government expenditure in the short term designed to help stimulate economic growth to counter the recession.

8 BORROWING STRATEGY

8.1 It is expected that there will not be a need for capital borrowing during 2009/10.

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:

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- 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 2009/10 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 2009/10 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 2009/10 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.

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9.4 Liquidity of Investments

- 9.4.1 Based on our cash flow forecasts, it is anticipated that fund balances in 2009/10 will range between £23m 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 60% of core funds 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.
- 9.5.3 The recent volatility in the financial markets and the failure of Icelandic banks identified weaknesses in the credit rating process and an over reliance on those agencies to determine counter party and duration risk. As a consequence of this and after consultation with our Treasury Adviser the risk assessment process for investments has been extended and now takes account of:
- Sovereign ratings;
 - Guarantees from governments and an assessment of whether those guarantees could be met;
 - Diversification;
 - Market intelligence;
 - Duration and other suggestions made by our treasury adviser; and
 - The application of Group and Sovereign limits (not including the UK).
- 9.5.4 In addition, the investment authorisation process has also been reviewed and for the foreseeable future overnight investment must be authorised by either the Chief Executive, Director of Finance or Chief Accountant. Investments for longer than overnight must be authorised in concert by two of those post holders.
- 9.5.5 The need to diversify risk across a wide range of qualifying counter parties, countries durations and instruments is addressed within the CIPFA Treasury Management Code.

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It has also been addressed in part within the Specified and Non Specified Investment **[Appendices 3 and 4]** and also by the application of individual counter party and group limits. In the aftermath of the Icelandic banks failure these limits are kept under constant review.

- 9.5.6 The application of the extended investment criteria and the consequent reduction in the number of counter parties on our approved list can make it difficult to place money when cash flows peak. It is for this reason that an application was made to the Government Debt Management Office for a deposit account facility in December 2008. Although this facility offers a minimal return it does guarantee the security of capital and should, therefore, be a useful tool in our investment armoury.

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 Because of the "credit crunch", the ongoing volatility in the financial markets, the restricted list of counter parties and the need for even great security of capital, it is intended to scale back the size of the portfolio managed by the in-house team. This will be achieved by transferring funds on maturity to our external fund manager and will reduce the level of funds being managed in-house from £10 to £5m by 31 March 2010.
- 9.8.2 The return on the investments held to maturity into 2009/10 and beyond should be in the order of 6%.

Externally managed core funds

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- 9.8.3 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.
- 9.8.4 The core balance to be discretionarily managed externally during 2009/10 is expected to rise to in the order of £20m because of the transfer of funds on maturity away from the in-house team to enhance the security of capital, as mentioned at 9.8.1 above.
- 9.8.5 The central case forecast of our fund manager is for a return of 2.75% and a best case return of 3.25% in 2009/10. This rate of return is based upon a scenario whereby the bank rate does not fall below 1.5% and the "credit crunch" effect puts an average premium of around 1.15% on LIBOR rates over the year. Should interest rates or the "credit crunch" premium fall below those levels, as is predicted by our treasury adviser and the market generally, then the return for the year is expected to fall commensurately.
- 9.8.6 The use of 5 to 7 year AAA rated supranational bonds currently yielding around 3.75% is to be considered as a means of improving returns in a low interest environment and of providing certainty of return. Before such an investment is made a risk assessment will be undertaken in conjunction with our treasury advisers.

Internally managed cash flow funds

- 9.8.7 The cash flow balance managed internally is expected to range from £0m to £10m, the higher figure generally applying immediately prior to precept dates.
- 9.8.8 In response to a climate of very low interest rates it is expected that call accounts, money market funds and short-dated deposits (1-3 months) will be used to benefit from the compounding of interest at potentially higher rates.
- 9.8.9 The expected return from cash flow investments for 2009/10 is expected to be in the region of 1.65% if the base rate does not fall below 1.5%. Should interest rates fall below 1.5%, as is predicted by our treasury adviser and the market generally, then the return for the year is expected to fall commensurately.

9.9 The position re Landsbanki

- 9.9.1 The Local Government Association is co-ordinating the efforts of all UK authorities with Icelandic investments. Members will be periodically updated on the latest developments of those efforts.
- 9.9.2 The next meeting of the Landsbanki Creditors meeting is scheduled for 20 February and it is hoped that this will go some considerable way towards identifying the net asset position and hence the degree of recovery we can expect.

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9.9.3 The Government informed local authorities in November 2008 that it intended to make a regulation to require local authorities to delay recognising any loss that may eventually be incurred on these investments until the financial year 2010/11.

9.10 End of year investment report

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