


Council

On 24 March 2003

Report title:	Treasury Strategy 2003-04
Report of:	Director of Finance
Wards affected:	All
1. Purpose	
1.1	To propose the Council's Treasury Strategy and Policy for 2003-04.
2. Recommendations	
2.1	To agree the proposed Treasury Strategy and Policy.
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3.1 Executive summary

3.1.1 The Treasury Strategy and Policy sets out the framework for the operation of the Council's Treasury management operation. Under the Financial Procedure Rules, paragraph C.13, the agreement of the strategy and policy is a matter for Council.

3.2 Reasons for any change in policy or for new policy development

3.2.1 No material changes.

4. Access to information: Local Government (Access to Information) Act 1985

The following background papers were used in the preparation of this report:

Sector's (the Council's treasury advisors) standard treasury management strategy
CIPFA Code of practice for treasury Management in Local Authorities

For access to the background papers or any further information please contact Justin Holliday on 020 8 489 3129.

5 **Background**

5.1 This Treasury Management Strategy Statement details the expected activities of the Treasury function in the forthcoming financial year (2003/04). Its production and submission to the Council is a requirement of the CIPFA Code of Practice on Treasury Management as adopted by the Council in May 2002.

5.2 The proposed strategy for 2003/04 in respect of the following aspects of the treasury management function is based upon the Director of Finance's views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor. The strategy covers:

- the current treasury position;
- treasury limits in force which will limit the treasury risk and activities of the Council;
- prospects for interest rates;
- the borrowing strategy;
- the investment strategy; and
- the extent of debt rescheduling opportunities.

5.3 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. The budget set by Council on 17 February so did.

6 **The Current Portfolio Position**

6.1 The Council's treasury portfolio position at 31 March 2003 is estimated to comprise:

		Principal	Average
Rate			-----
Fixed Rate Funding	PWLB	£563m	
	Market	£ 2m	
Total Debt		£565m	8.85%
Total Investments		£90m	3.8%
Borrowing requirement for 2003/04:			
Borrowing approvals		£20m	
Principal repayments		£ 2m	
Minimum Revenue Provision		£(14)m	
Reserved Capital receipts		£(10)m	
Net requirement		£ - m	

7 Treasury limits for 2003/04

7.1 The overall treasury position is broadly unchanged and, therefore, it is proposed not to change the limits on the Council's treasury management activities. The following limits are proposed for 2003/04:

- Overall borrowing limit £600m
- Short term borrowing limit £50m
- Proportion of interest at variable rates 10%

8 Prospect for interest rates

8.1 The Council appointed Sector Treasury Services as its treasury adviser and part of their service is to assist the Council to formulate a view on interest rates. Appendix A 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 gives the UBS forecast which is Sector's central view:

(%)	Current	Q1 2003	Q2 2003	Q3 2003	Q4 2003
Base Rate	3.75%	3.75%	3.75%	3.75%	3.75%
10 year gilt	4.23%	4.50%	4.50%	4.50%	4.50%
30 year gilt	4.28%	4.25%	4.25%	4.25%	4.25%

8.2 The Sector view on interest rates is as follows:

8.2.1 There is also a risk that base rate could fall to 3.50% for some months during the above period, but rising back to 3.75% by the end of 2003. In addition, there is a

risk that gilt yields between 10 and 30 years could drop to 4.0% for limited periods. Equally, yields could rise above those forecast if equity values recover from the lows of 2002.

8.2.2 Shorter term rates - The strong economic bounce back in the US in quarter 1 of 2002 from the recession of 2001 was not sustained in quarter 2. Quarter 3 was stronger but growth weakened again in quarter 4 and is expected to be lack lustre in 2003. This will create an environment of overall weak world economic growth. Fear of war in Iraq has undermined share values further after the initial fall caused by the fallout from all the corporate accounting scandals in the US during the first half of 2002; they have staged a partial recovery towards the end of 2002 but have since fallen back again to six year lows. The US Federal Reserve Bank cut its central rate by 0.5% to 1.25% in November 2002 to counter prolonged weak economic growth, and falling share values (which undermine consumer confidence and thereby consumer expenditure). In the UK, base rate was unexpectedly cut by 0.25% to 3.75% in February as the focus of MPC concern shifted to prospects of a weakening UK economy from particular concerns for excessive house price increases and increases in consumer borrowing. While our central forecast is for base rate to remain unchanged for the rest of 2003, there are risks to the downside for some months if growth prospects weaken further, before climbing back to 3.75% around the end of the year.

8.2.3 Longer-term interest rates – PWLB rates have fallen considerably during 2002 as a result of safe haven flows of investment money where investors sell equities, and buy government bonds (gilts), so causing fixed interest rates to fall. This has consequently depressed PWLB rates below normally expected levels. While fears of war on Iraq remain, these rates are expected to continue to be lower than normal and could fall further if there was a renewed flight to quality. In addition, the outlook for share values is not promising as corporate profit growth is expected to be weak, reflecting the overall weak rate of world growth. Consequently, a major reversal of the flight from shares into bonds in 2002 is not forecast for 2003. Gilt yields are therefore expected to remain at below normal levels in 2003 in sympathy with low international government bond yields in the worldwide low growth environment.

9 Capital Borrowings and the Borrowing Portfolio Strategy

9.1 Based upon the prospects for interest rates outlined above, there are a number of strategy options available. The anticipation is that short-term rates will continue to be cheaper than long fixed rate borrowing for most of 2003/04. Short term rates are expected to be relatively stable at or near current levels. Long term rates are not currently expected to move far but if there is a major rally in share prices, then long rates would be susceptible to a corresponding rise. These expectations suggest that:

- short term rates will be good value compared to long term rates, and are expected to be relatively stable for a reasonable period, so that best value will be found by borrowing short term at variable rates, or for short fixed periods, in order to minimise borrowing costs in the short term or to make short term savings required in order to meet budgetary constraints; however,
- the risks intrinsic in the shorter term variable rates are such, when compared to relatively low long term funding, which may be achievable in 2003/04, that the Council will maintain a stable, longer term portfolio by drawing longer term fixed rate funding at a marginally higher rate.

9.2 This strategy position is in the context of both a mature debt portfolio with no additional borrowing requirement for 2003/04 and an incentive from the housing finance system which encourages authorities to maintain their borrowing at or around the credit ceiling. In practice, the strategy bites in a debt rescheduling scenario, which is explored in more detail in below.

9.3 Against this background caution will be adopted with the 2003/04 treasury operations. The Director of Finance will monitor the interest rate market and adopt a pragmatic approach to any changing circumstances, reporting any decisions as required by the policy.

9.4 **Sensitivity of the forecast** - The main sensitivities of the forecast are likely to be the two scenarios below. The Council officers, in conjunction with the treasury advisers, will continually monitor both the prevailing interest rates and the market forecasts, adopting the following responses to a change of view:

- *an unexpected sharp rise in long and short term rates*, perhaps arising from an increase in world economic activity. In this event the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are relatively cheap; and
- *an unexpected sharp fall in long and short term rates*, due to e.g. growth rates remaining low or weakening. In this event long term borrowings will be postponed, and any rescheduling from fixed rate funding into variable or short rate funding will be exercised.

10 Temporary Investments Strategy

10.1 The money market yield curve is currently anticipating a falling base rate for the next year. This authority views the markets' expectation for base rates as being too low, and investments will be kept short, with a view to enabling returns to be compounded more frequently.

10.2 The Council operates a PFI reserve to hold the earmarked PFI grant which is received from government sometime before it is required to pay the PFI provider.

The Council will seek opportunities to invest the resources within the PFI reserve to lock in to higher long term returns should such an opportunity occur. Certain of the investment opportunities are market traded instruments. The auditor's view on these is that any (notional) gain or loss on these would need to be brought to account annually. Any such (notional) transaction would be accounted for by transactions to (or from) the PFI reserve.

10.3 Investments will be made in accordance with the Approved Investments Regulations (1990) and subsequent amendments, and with institutions as set out by the policy, that is the ratings matrix produced by our advisors.

11 **Debt rescheduling**

11.1 The current and forecasted structure of interest rates do not provide a favourable scenario for most debt restructuring. The potential for debt restructuring will be monitored in the light of interest rates. Any positions taken via rescheduling will be in accordance with the strategy position outlined in Section 5 above. The reasons for any rescheduling to take place will include:

- the generation of cash savings at minimum risk;
- in order to help fulfil the strategy outlined in Section 5 above; and
- in order to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of volatility).

11.2 Changes to the item 8 subsidy determination for 2003/04 effectively allow a choice of funding methods for the premium arising from any restructuring. This may make an number of restructurings less financially unattractive. This will be kept under review.

11.3 All rescheduling will be reported as required by the policy.

12 **Policy**

12.1 The revised policy for 2003/04 is shown at Appendix B.

INTEREST RATE FORECASTS

(as prepared by Sector)

The data below shows a variety of forecasts published by a number of institutions. The first three are individual forecasts including those of UBS and Capital Economics (an independent forecasting consultancy), who both provide our economic forecasting. The final two represent summarised figures drawn from the population of all major City banks and academic institutions. The current data shows the rates at the time of issue, not necessarily current rates. The forecast within this strategy statement has been drawn from these diverse sources and officers' own views.

1. INDIVIDUAL FORECASTS

UBS Warburg Economic interest rate forecast (for quarter ends) - February 2003

(%)	Current	Q1 2003	Q2 2003	Q3 2003	Q4 2003
Base Rate	3.75%	3.75%	3.75%	3.75%	3.75%
10 year gilt	4.23%	4.50%	4.50%	4.50%	4.50%
30 year gilt	4.28%	4.25%	4.25%	4.25%	4.25%

Capital Economics interest rate forecast – February 2003

(%)	Current	Q1 2003	Q2 2003	Q3 2003	Q4 2003	Q1 2004	Q2 2004
Base Rate	3.75%	3.75%	3.50%	3.50%	3.50%	3.50%	3.50%
10 year gilt	4.23%	4.60%	4.50%	4.40%	4.20%	4.20%	
20 year gilt	4.28%	4.60%	4.50%	4.50%	4.40%	4.40%	

HSBC interest rate forecast – December 2002

(%)	Current	Q1 2003	Q2 2003	Q3 2003	Q4 2003
Base Rate	4.00%	4.00%	4.00%	4.00%	4.00%
10 year gilt	4.23%	4.50%	4.30%	4.20%	4.20%
30 year gilt	4.28%	4.40%	4.40%	4.40%	4.30%

2. SURVEYS OF ECONOMIC FORECASTS

HM Treasury - summary of 35 independent forecasters views of base rate – as at January 2003 (2004 - 2006 are as at November 2002 but are based on 11 forecasts)

(%)	2003	2004	2004	2005	2006
	Year end	Year end	average	Average	Average
Average	4.27%	4.59%	5.14%	5.12%	4.81%
Highest	5.00%	6.40%	6.10%	5.60%	5.00%
Lowest	3.01%	3.00%	4.60%	4.90%	4.50%

Consensus Forecasts - summary view of 25 city houses on the likely change in short term and 10 year fixed interest rates (January 2003)

(%)	Jan - 03	April - 03	Jan - 04
3 month interbank - average	3.88%	4.00%	4.40%
High	3.88%	4.60%	5.20%
Low	3.88%	3.60%	3.50%
10 year gilt yield - average	4.32%	4.50%	4.60%
High	4.32%	4.60%	5.50%
Low	4.32%	4.20%	4.00%

Treasury Management Policy
(as reviewed for financial year 2003/04)

1 Introduction

1.1 This policy is prepared in accordance with the Code of Practice on Treasury Management in Local Authorities, published by CIPFA ('the Code'). The code defines treasury management as:

"the management of the local authority's cash flows, its borrowings and its investments, the management of the associated risks, and the pursuit of the optimum performance or return consistent with those risks".

1.2 This policy sets out how the Council implements the Code.

2 Approved activities

2.1 The approved activities for the treasury management function are:

- borrowing
- lending
- debt repayment and rescheduling
- consideration, approval and use of financial instruments and treasury management techniques
- managing the underlying risk associated with the Council's capital financing and cashflows
- leasing.

3 Strategy

3.1 An annual strategy report will be presented to Council. The report will set out projections of treasury management activity for the year and for subsequent years and propose actions to be taken.

3.2 The strategy will consider:

- interest rate prospects
- borrowing strategy
- investment strategy
- debt rescheduling
- any other treasury management activity

3.3 The strategy will further set out:

- the Council's overall borrowing limit
- the Council's short term borrowing limit
- the maximum proportion of the Council's debt with a variable interest rate.

4 **Approved methods and sources of funding**

4.1 Borrowing is raised in accordance with the Local Government and Housing Act (1989) and is permitted via the following instruments:

- overdraft
- short term loans
- Public Works Loan Board loans
- other loan instruments.

5 **Approved investments**

5.1 Investment is permitted with the following organisations registered in the UK, European Union or North America, up to the following investment limits.

Counterparty	Limit £m
All banks authorised under the banking Act 1987 which have an acceptable rating in the rating matrix	10
The Council's banker (currently the Co-operative bank PLC)	7
All building societies which have an acceptable rating in the rating matrix	10
Discount houses for secured deposits which have an acceptable rating in the rating matrix	10
Local Authorities	10
HM Government	20
Money Market Funds	10

5.2 The ratings matrix referred to in the above table is prepared by the Council's treasury advisors.

5.3 The Council is also permitted to invest using instruments permitted under the terms of The Local Authorities (Capital Finance) (Approved Investment) Regulations 1990 (as amended). Limits for institutions will be set such that they

are, in terms of the financial standing of the counterparty, consistent with those in paragraph 5.1 with an absolute counterparty limit of £20 million.

6 **Brokers and advisors**

6.1 The following brokers are approved for open market transactions:

- Garbon Intercapital PLC
- Prebon Marshall Yamane (UK) Ltd
- Tradition UK Ltd
- Tullet and Tokyo London Ltd
- The Co-operative Bank PLC
- Martins Brokers (UK) PLC

6.2 The following brokers are approved for leasing transactions:

- Capita Leasing Services Ltd
- Unilink
- Dovetail solutions Ltd.

6.3 The Council's treasury management advisor is Sector.

7 **External managers**

7.1 The use of external managers is not permitted.

8 **Delegation**

8.1 The following delegations will apply for treasury management:

Council

Annual review of policy.

Consideration of the strategy.

Lead member

Monitoring of the implementation of the policy and strategy.

Director of Finance

Implementation of the policy and strategy, including the authority to raise loans, enter into leases and make investments. In each case, in accordance with procedures determined by the Director of Finance and set out in a Treasury Management Systems Document.

9 **Reporting**

9.1 The Director of Finance will:

- prepare an annual strategy report and review of the policy for the consideration of Council;
- report annually to the Executive on the achievement of the previous year's strategy;
- report relevant, key details of the treasury management activities to the lead member.

