| | |
|---|---|
| **REPORT TO:** | Executive Board Sub-Committee |
| **DATE:** | 9th September 2010 |
| **REPORTING OFFICER:** | Operational Director – Finance |
| **TITLE:** | Treasury Management 2009/10 |
| **WARDS:** | |

## 1.0 PURPOSE OF REPORT

1.1 To review treasury management during 2009/10 in accordance with the Halton Borough Council's Treasury Management Policy Statement.

## 2.0 RECOMMENDED: That the report be noted.

## 3.0 SUPPORTING INFORMATION

3.1 The annual review is attached in the Appendix. The 2009/10 financial year started with markets still badly disrupted following the effects of 2008, which saw one financial institution after another collapsing or being taken over in the wake of the credit crunch. The impact was felt the most in the UK following the collapse of the Icelandic banks and the near collapse of three major UK banks which received significant central government support. 2009/10 witnessed the real economy suffering from a lack of credit, short and medium term interest rates at record lows and a great deal of anxiety as to how or when recovery would start to take place.

3.2 During 2009, the Monetary Policy Committee (MPC) embarked on a programme of Quantitative Easing (QE) aimed at pumping liquidity into the economy to stimulate growth. The programme reached £200bn in November 2009. Bank rate set by the MPC remained at an all time low of 0.5% for the whole year.

## 4.0 POLICY IMPLICATIONS

4.1 Credit ratings are one method used by Halton Borough Council to assess the credit worthiness of counterparties on its approved list for short term investments. Following the events of 2008 and 2009, many of the Authority's approved counterparties remain on credit watch or fell below the minimum criteria specified in the Treasury Management Policy (TMP). These restrictions placed a heavy burden on the Council to find a suitable counterparty to invest deposits with whilst maintaining priority towards Security, Liquidity and Yield.

## 5.0 OTHER IMPLICATIONS

5.1 The Treasury Management function has consistently contributed to the budget and helped fund local services. In 2009/10, Treasury Management generated £0.282m additional investment income by locking in investments during 2008.

5.2 The remaining long term investments are due to mature in the latter part of 2010/11. As a consequence, it is anticipated that investment income will reduce significantly in 2010/11 as investment rates will continue to generate significantly less returns on investment.

## 6.0 IMPLICATIONS FOR THE COUNCIL'S PRIORITIES

### 6.1 Children and Young People in Halton

None.

### 6.2 Employment, Learning and Skills in Halton

None.

### 6.3 A Healthy Halton

None.

### 6.4 A Safer Halton

None.

### 6.5 Halton's Urban Renewal

None.

## 7.0 RISK ANALYSIS

7.1 The main risks associated with Treasury Management are security of investment and volatility of return. To combat this, the Authority operates within a clearly defined Treasury Management Policy and an annual Borrowing and Investment Strategy which sets out the control framework.

## 8.0 EQUALITY AND DIVERSITY ISSUES

8.1 There are no issues under this heading.

## 9.0 LIST OF BACKGROUND PAPERS UNDER SECTION 100D OF THE LOCAL GOVERNMENT ACT 1972

| Document | Place of Inspection | Contact Officer |
| --- | --- | --- |
| Working papers | Financial Management Division | M. Lloyd |

**APPENDIX**

**Treasury Management – Annual Review 2009/10**

## 1.0 Introduction and Background

1.1 Treasury management in local government is regulated by the 2009 CIPFA Code of Practice on Treasury Management in Local Authorities (the Code). Halton Borough Council has adopted the Code and fully complies with its requirements. The primary requirement of the Code is the formulation and agreement by full Council of a Treasury Policy Statement which sets out Council, Executive Board Sub-Committee, Business Efficiency Board and Operational Director – Finance responsibilities, delegation and reporting arrangements.

1.2 A requirement of the Council's Treasury Policy Statement is the reporting to the Executive Board Sub-Committee of both the expected treasury activity for the forthcoming financial year (the annual Treasury Strategy Statement) and subsequently the results of the Council's treasury management activities in that year (this annual treasury report).

1.3 Treasury Management is defined as "The management of the Local Authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimal performance consistent with those risks.

1.4 This annual report covers:

- The current treasury position;
- Performance Measurement;
- The Borrowing Strategy for 2009/10 (Appendix A & B);
- The Borrowing Outturn for 2009/10;
- Compliance with Treasury limits and Prudential Indicators;
- The Investment Strategy for 2009/10;
- The Investment Outturn for 2009/10;
- Debt Rescheduling;
- Other issues.

## 2.0 Current Portfolio Position

2.1 Halton Borough Council's debt and investment position at the beginning and end of the year was as follows:

| | 31st March 2010 | | | | 31st March 2009 | | |
|---|---|---|---|---|---|---|---|
| | Principal £m | £m | Rate % | Life Yrs | Principal £m | Rate % | Life Yrs |
| Fixed Rate Funding | | | | | | | |
| - PWLB | 10.00 | | 3.70 | 47 | 10.00 | 3.70 | 48 |
| - Market | 10.00 | 20.00 | 4.42 | 0-57 | 10.00 | 4.42 | 0-58 |
| Variable Rate Funding | | | | | | | |
| - PWLB | 0.00 | | | | 10.00 | | |
| - Market | 2.00 | 2.00 | 0.32 | | 10.70 | 1.78 | |
| **Total Debt** | | **22.00** | **2.20** | | **40.70** | **2.90** | |
| Investments | | | | | | | |
| - In House | 16.10 | | 4.65 | | 39.00 | 6.17 | |
| - With Managers | 0.00 | 16.10 | | | 0.00 | | |
| **Total Investments** | | **16.10** | **4.65** | | **39.00** | **6.17** | |

## 3.0 Performance Measurement

3.1 One of the key changes in the revision of the Code was the formal introduction of performance measurement relating to investments, debt and capital financing activities. Whilst investment performance criteria have been well developed and universally accepted, debt performance indicators continue to be a more problematic area with the traditional average portfolio rate of interest acting as the main guide (as used in the table above).

CIPFA has however issued draft indicators, although accompanied by a cautionary note. In effect, these represent a potential range of statistics which will not give a definitive set of indicators, but will rather aid comparison with neighbouring authorities treasury structures. The use of benchmarks for investments may be inappropriate for those Local Authorities with relatively small cash balances, such as Halton.

## 4.0 The Prospect for Interest Rates for 2009/10.

Section 4.0 is reproduced from the Treasury Management Strategy approved by Executive Board on 12th February 2009.

See Appendix A

## 5.0 Capital Borrowings and the Borrowing Portfolio Strategy

Section 5.0 is reproduced from the Treasury Management Strategy approved by Executive Board on 12th February 2009.

See Appendix B

## 6.0 Outturn for 2009/10

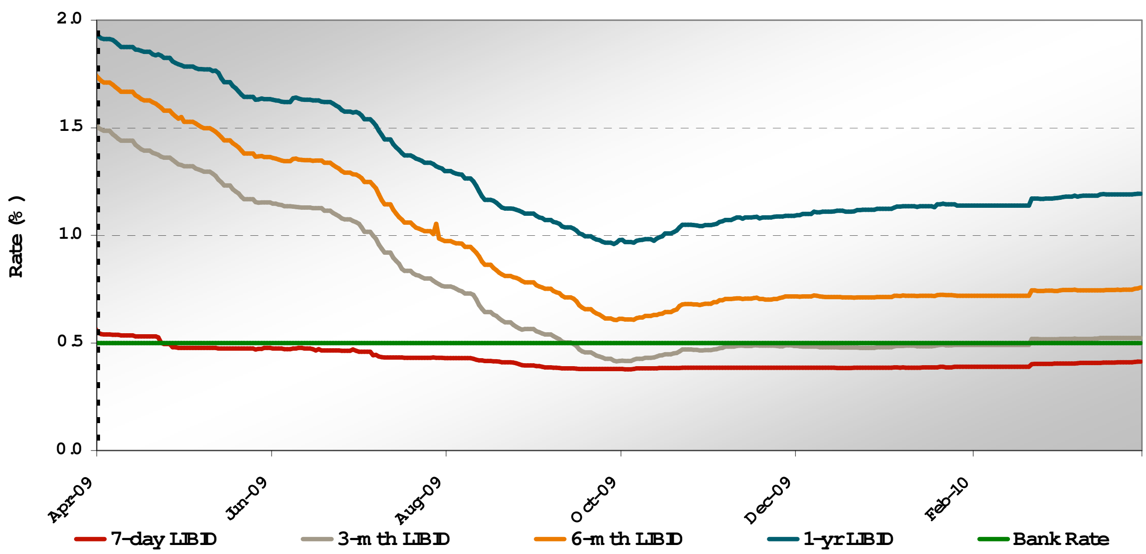
6.1 The Economy and Interest Rates

During 2009/10, the Monetary Policy Committee (MPC) was focused on helping the economy to turn around from plunging into the deepest and longest recession the UK economy had experienced for many years.

Despite keeping the Bank Rate at an unprecedented historical low of 0.5% all year, the MPC also had to resort to extreme measures in terms of pumping liquidity into the economy through Quantitative Easing (QE) by purchasing £200bn gilts and corporate bonds. This had the effect of boosting prices for gilts and corporate bonds and therefore bringing down yields, reducing borrowing costs for both the corporate and public sector.

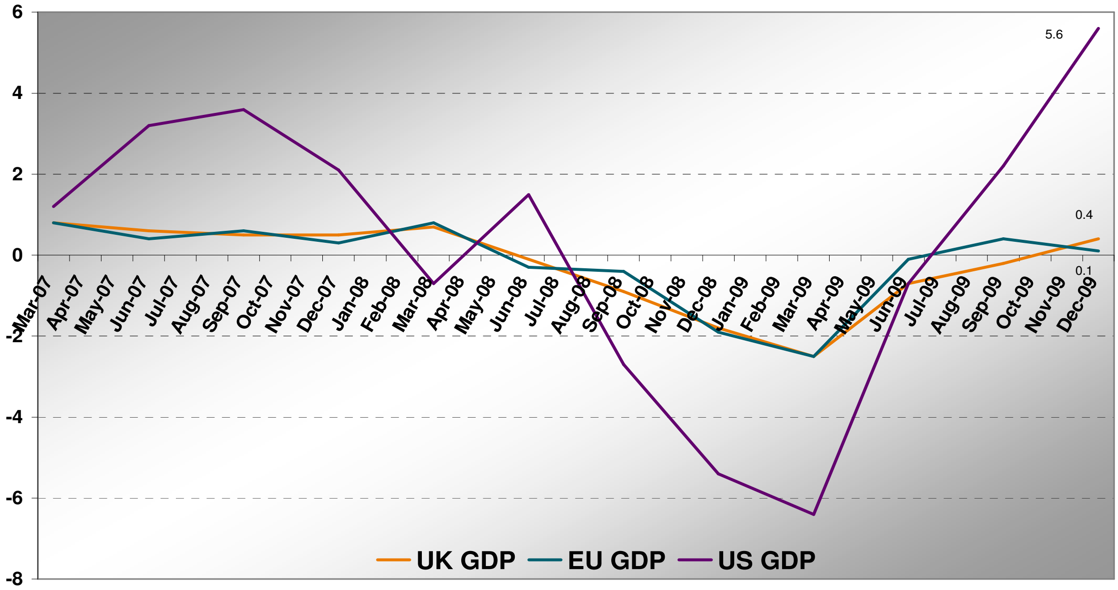
It was notable that the increase in money supply in the economy generated by this programme brought the credit crunch induced spread between Bank Rate and 3-month LIBID (investment rate that depositors could earn) down from 0.95% at the beginning of the financial year to zero during August 2009.

**Investment Rates 2009-10**



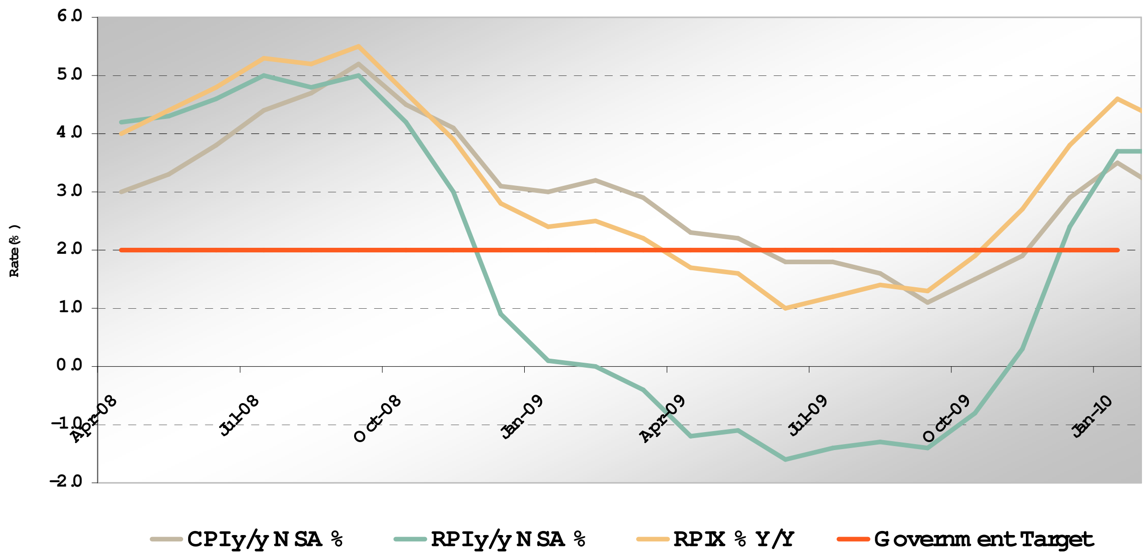
The dominant focus in 2009/10 was on quarterly GDP growth figures. The recession bottomed out in quarter 1 of 2009. There was then major disappointment that the end of the recession failed to materialise in quarter 3 2009, but the forth quarter of 2009 did then see economic growth return at +0.4%.

**GDP % quarter / quarter**




Inflation had not been a major concern of the MPC as it fell back below the 2% target level from June to November. However, it did spike upwards to reach 3.5% on the back of the unwinding of the temporary cut in VAT to 15% on 1 January 2010. This was not seen as a cause for alarm as this spike was expected to fall out of the inflation index and inflation was forecast by the Bank of England to fall back under target by the end of 2010.

**UK Inflation April 2008 – March 2010**



The financial year ended with markets gradually gaining in confidence and optimism that the economy was indeed on the path to recovery, although it appeared to be fragile, and with some residual risk that there could still be a double dip recession. The optimism was further enhanced by a return to strong economic growth in the US towards the end of 2009. The year also saw a major resurgence in share prices in the US, UK and Europe from a very depressed level in March 2009 on the back of the rise in optimism.

## 7.0 Borrowing and Investment Rates in 2009/10

**12-month rate:** this started the year at a credit crunch enhanced rate of 1.85% and fell steadily until reaching 0.85% in September. Since then, it has risen to finish the year at 1.15% as the market looked ahead to when the MPC would have to start raising Bank Rate from its then current rate of 0.50%

**5-year (and 10-year) PWLB rate:** this started the year at 2.54% (3.36%) and then fell to a low for the year of 2.47% (3.30%) on the following day, before then rising sharply to hit a peak of 3.29% (4.15%) in July. From there it fell until reaching 2.54% (3.55%) in October and then rose back up to a peak of 3.13% (4.42%) in January. It finished the year at 2.89% (4.19%).

**25-year (and 50-year) PWLB rate:** This started the year at 4.28% (4.57%) and then peaked in the 4.70's during June – August (4.85% June) before falling back to a bottom of 4.07% (4.18%) in October. From there, it rose again towards the end of the year to return to the 4.70's and peaked at 4.83% in February (4.79% March). It finished the year at 4.67% (4.70%).

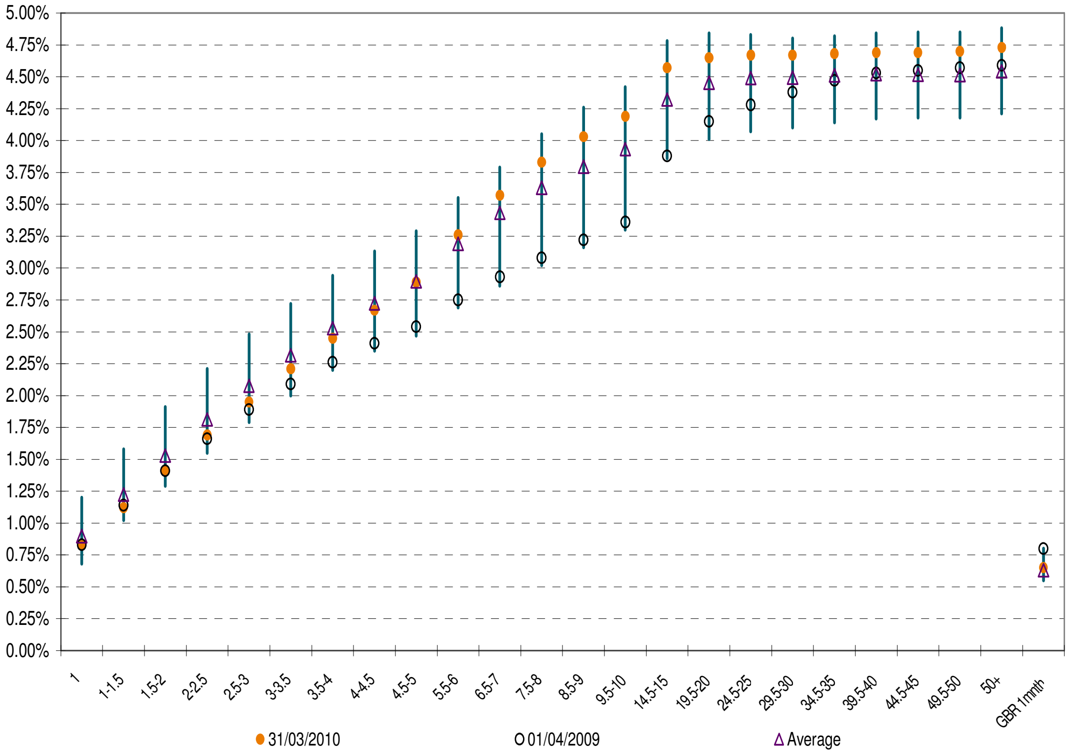
## 8.0 Borrowing Outturn 2009/10

8.1 As comparative performance indicators, average PWLB maturity loan interest rates for 2009/10 were:

| | | |
|---|---|---|
| 1 year | 0.90% | *(2008/9 3.26%)* |
| 9.5 - 10 year | 3.93% | *(2008/9 4.47%)* |
| 24.5 - 25 year | 4.49% | *(2008/9 4.57%)* |
| 49.5 – 50 year | 4.51% | *(2008/9 4.44%)* |
| 1 month variable | 0.63% | *(2008/9 3.68%)* |

The graph below shows the range (high and low points) in rates for each maturity period during the year, and individual rates at the start and end of the financial year:

**PWLB Rates 2009/10**




8.2 Debt Performance

As highlighted in 2.1, the average debt portfolio interest rate has moved over the course of the year from 2.90% to 2.20% (although the long term core rate stayed the same at 4.06%). The strategy for the year was to fund borrowing from surplus cash unless rates were particularly attractive when the Council would draw longer term fixed rate debt.

8.3 There was no new long term borrowing transactions in the year.

## 9.0 Compliance with Treasury Limits

9.1 During the financial year, the Council operated within the treasury limits set out in the Council's Treasury Policy Statement and Treasury Strategy Statement.

## 10.0 Temporary Investments Strategy

Section 10.0 is reproduced from the Annual Investment Strategy approved by Executive Board on 12th February 2009.

See Appendix C

## 11.0 Investment Outturn for 2009/10

11.1 Halton Borough Council manages its investments in-house and invests with the institutions listed in the Council's approved lending list. The Council invests for a range of periods from overnight to 3 years, dependant on the Council's cash flows, counterparty limits and the interest rates on offer.

11.2 Detailed below is the result of the investment strategy undertaken by the Council:

| | Average Investment Level | Rate of Return (gross of fees) | Rate of Return (net of fees) | Benchmark Return |
|---|---|---|---|---|
| Internally Managed | £37.890m | 4.27% | N/A | 0.42% |

11.3 The benchmark for internally managed funds is the average 7-day LIBID rate sourced from the Financial Times.

11.4 During 2008, the Council locked in a number of investments at a significantly higher rate of return than the LIBID benchmark rate.

## 12.0 Debt Rescheduling

12.1 The post housing stock transfer debt situation has left Halton Borough Council in a unique situation. It has a low level of external debt at £20m, £10m of which is locked into an excellent rate of 3.70% for a long period. It is unlikely that this debt would be rescheduled as it provides a cornerstone of the debt portfolio for future years.

## 13.0 Other Issues

13.1 Counterparties

Due to the high level of uncertainty in the money markets during the year, Halton Borough Council was particularly careful in monitoring the suitability of the organisations on its approved investment counterparty list. There have been a number of counterparties who have been suspended from the list due to their credit rating not meeting the minimum requirements set out in the Annual Investment Strategy.

Halton Borough Council places the security of capital as its number one priority. As a direct consequence, it is expected that there will be a declining level of investment income during the remainder of 2010/11, as various long term fixed rate deposits mature.

Halton Borough Council has never had the Icelandic Banks on its counterparty list and was therefore unaffected by their default in October 2008.

**Appendix A**

## 4.0 PROSPECTS FOR INTEREST RATES

4.1 The Council appointed Sector Treasury Services as a treasury adviser to the Council 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.

4.2 Sector View: Interest rate forecast – 6th December 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 | Q/E2 2011 | Q/E3 2011 | Q4 2011 | Q1 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 |
| 5 yr 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 |
| 10 yr 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 |
| 25 yr 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 |
| 50 yr 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 |

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.

4.3 Economic background

**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.

**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.

- 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 and by its biggest ever cut of 75bp on 4 December to reach 2.5%.

**United Kingdom**

- 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.

- 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 and by a further 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 has 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.

**Appendix B**

## 5.0 CAPITAL BORROWINGS AND THE BORROWING PORTFOLIO STRATEGY

5.1 The Sector forecast is as follows.

(These forecasts are based around an expectation that there will normally be variations of +/- 25bp during each quarter around these average forecasts in normal economic and political circumstances. However, greater variations can occur if should there be any unexpected shocks to financial and/or political systems.) These forecasts are for the PWLB new borrowing rate: -

- The 50 year PWLB rate is expected to remain around current levels of about 3.80 - 3.90% until Q2 2010 when it is forecast to rise to 4.00%. The rate then edges up gradually to reach 5.00% at the end of the forecast period.

- The 25 year PWLB rate is expected to drop to 3.95% in Q1 2009 and stay around there until starting to rise in Q1 2010 and then to eventually reach 5.05% at the end of the forecast period.

- The 10 year PWLB rate is expected to drop to 2.55% in Q3 2009 but then to start rising again in Q2 2010 to eventually reach 4.85% at the end of the forecast period.

- The 5 year PWLB rate is expected to fall to a floor of 2.15% during Q3 2009. The rate then starts rising in Q2 2010 to eventually reach 4.60% at the end of the forecast period.

This forecast indicates, therefore, that there is a range of options available for borrowing strategy for 2009/10. Variable rate borrowing is expected to be cheaper than long term borrowing and will therefore be attractive throughout the financial year compared to simply taking long term fixed rate borrowing. Under 10 year PWLB rates are expected to be substantially lower than longer term PWLB rates so this will open up a range of choices for new borrowing for authorities that want to spread their debt maturities away from a concentration in long dated debt. Rates are expected to be slightly lower at the middle to end of the year than earlier on so it may be advantageous to borrow later in the year.

For authorities wishing to minimise their debt interest costs, the main strategy is therefore as follows:

- For authorities wanting to focus on the very cheapest PWLB borrowing, the under 10 year rates will provide significantly cheaper rates than longer term borrowing. Under 5 year rates are also expected to be significantly lower than 5-10 year rates. Rates are expected to be slightly lower at the middle to end of the year than earlier on so it may be advantageous to borrow later in the year.

- For authorities wanting to lock into historically low long term rates, there is expected to be little difference between 25 year and 50 year rates. However, despite the minimally more expensive new borrowing rates expected in the 25 – 30 year period later in the year, these could be seen as being much more attractive than 50 year borrowing as the spread between the PWLB new borrowing and early repayment rates is considerably less. This then maximises the potential for debt rescheduling at a later time by minimising the spread between these two rates.

- This strategy would also mean that after some years of focusing on borrowing at or near the 50 year period, local authorities would be able to undertake borrowing in a markedly different period and so achieve a better spread in their debt maturity profile.

- When long term PWLB rates fall back to the central forecast rate of about 3.95%, borrowing should be made at any time in the financial year. A suitable trigger point for considering new fixed rate long term borrowing, therefore, would be 3.95%. The central forecast rate will be reviewed in the light of movements in the slope of the yield curve, spreads between PWLB new borrowing and early payment rates, and any further changes that the PWLB may introduce to their lending policy and operations.

- Consideration will also be given to borrowing fixed rate market loans at 25 – 50 basis points below the PWLB target rate if they become available again.

**External v. internal borrowing**

- The next financial year is expected to be a time of historically abnormally low Bank Rate. This opens up an opportunity for authorities to fundamentally review their strategy of undertaking external borrowing.
- For those authorities with investments in excess of their borrowing requirement over the next year and access to the cash from maturing investments within the financial year, then consideration also needs to be given to the potential merits of internal borrowing.
- As long term borrowing rates are expected to be higher than rates on the loss of investment income and look likely to be so for the next couple of years or so, authorities may prefer to avoid all new external borrowing in the next financial year in order to maximise savings in the short term.
- The running down of investments also has benefits of reducing exposure to interest rate and credit risk.

Against this background caution will be adopted with the 2009/10 treasury operations. The Director of Finance will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to Executive Board Sub-Committee at the next available opportunity.

**Sensitivity of the forecast** – In normal times 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 sentiment:

- *if it were felt that there was a significant risk of a sharp rise in long and short term rates,* perhaps arising from a greater than expected increase in world economic activity or further increases in inflation, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

- *if it were felt that there was a significant risk of a sharp fall in long and short term rates,* due to e.g. growth rates weakening, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term funding will be considered.

However, after the freezing of some local authority investments by Icelandic banks now in receivership, many local authorities are currently concerned about the safety of investments and the ability of authorities to rely on credit ratings as a basis for ensuring that investments can be undertaken safely, especially for longer periods of time. The approach of this authority is therefore to be extra vigilant in reviewing its counterparties, especially for larger deals and to minimise the risk by spreading investments across the whole range of counterparties.

**Appendix C**

## 10.0 ANNUAL INVESTMENT STRATEGY

10.1 Investment Policy

The 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:

(a) the security of capital; and

(b) the liquidity of its investments.

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

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.

Investment instruments identified for use in the financial year are listed below under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the approved lending list.

Specified v non specified investments

There has been an increasing number of innovative investment products being marketed over the past few years. The have arisen due to the relatively low interest rate environment which has prevailed during this period. The initial guidance from the ODPM focused on high security and more particularly credit risk. This approach however does not deal with market risk, which is the sudden adverse movement in interest rates. In some products this could lead to a significant diminution of the maturity value below that of the original sum invested.

Because of this it has been suggested that if any investment other than a straight cash deposit is envisaged the following tests are applied ;-

1. the working of the product is fully understood;

2. the degree of risk exposure the product carries is identified;

3. the level of risk fits within the parameters set by the authority;

4. the product complies with the CIPFA Code of Practice on Treasury Management (prime focus on security and best value applied to optimise returns).

The Council has in the main used straightforward cash deposits, with both fixed and variable rates, but always with options to repay if the counterparty wanted to change the terms and agreement couldn't be reached. The issue therefore still boils down to credit risk and this is handled through the counterparty weighted rankings and prudential indicators which limit the amount that can be placed with non rated organisations at any one time.

Specified Investments:

All such investments will be sterling denominated, with maturities up to maximum of 1 year, meeting the minimum 'high' rating criteria where applicable (i.e. credit rated counterparties).

| | Minimum 'High' Credit Criteria | Use |
|---|---|---|
| Debt Management Agency Deposit Facility | -- | In-house |
| Term Deposits – UK Government | -- | In-house |
| Term Deposits – Other LAs | -- | In-house |
| Term Deposits – Banks and Building Societies | On Approved List and Rated AA or above | In-house |

If forward deposits are to be made, the forward period plus the deal period should not exceed one year in aggregate.

Non-Specified Investments:

A maximum of 30% will be held in aggregate in non-specified investments for 2-3 years and 60% in 1 to 2 years. This group is to include non credit rated organisations.

| | Minimum Credit Criteria | Use | Max % of Total Investments | Max. Maturity Period |
|---|---|---|---|---|
| Term deposits – UK government (with maturities in excess of 1 year) | - | In-house | 30%<br>60% | 2-3 years<br>1-2 years |
| Term deposits – other LAs (with maturities in excess of 1 year) | - | In-house | 30%<br>50% | 2-3 years<br>1-2 years |
| Term deposits – banks and building societies (with maturities in excess of 1 year) | On Approved List and less than AA or Unrated. | In-house | 30%<br>60% | 2-3 years<br>1-2 years |

The Council uses Moody's ratings to derive its criteria. Where a counterparty does not have a Moody's rating, the equivalent Fitch rating will be used. All credit ratings will be monitored on a regular basis. The Council is alerted to changes in credit ratings through its use of the 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.

10.2 Investment Strategy

In-house funds: The Council's in-house managed funds have during the past twelve months (January to December) been in the value range of £40.00m to £54.20m with a core balance of around £20m which is available for investment over a longer (say) 2-3 year period. The current balance is £54.05m. Investments will accordingly be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

The Council already has investments that span the financial year e.g. longer-dated deposits, which were taken out at various peaks of the last rate cycles as shown below.

| | Amount (£000) | Maturity | Rate (%) |
|---|---|---|---|
| Cumberland BS | 1,000 | 29/04/2009 | 5.87 |
| Cumberland BS | 500 | 29/04/2009 | 5.87 |
| Nationwide BS | 2,500 | 18/05/2009 | 6.20 |
| West Bromwich BS | 2,500 | 11/08/2009 | 6.25 |
| Stroud & Swindon BS | 2,500 | 18/08/2009 | 6.22 |
| HBOS Treasury Services | 5,000 | 04/09/2009 | 6.35 |
| Nationwide BS | 10,000 | 27/10/2009 | 5.85 |
| Nationwide BS (ex Cheshire BS) | 2,500 | 02/11/2009 | 6.15 |
| Dunfermline BS | 2,500 | 07/12/2009 | 6.56 |
| Newcastle BS | 2,500 | 07/06/2010 | 6.53 |
| Northern Rock Plc | 2,500 | 23/07/2010 | 6.41 |
| Skipton BS | 5,000 | 03/11/2010 | 6.15 |

It is unlikely therefore that further long dated investments will be undertaken until these investments mature or rates improve.

The interest rate outlook is particularly relevant to the performance of the Council's investment portfolio. Appendix 'A' shows quite clearly that all economic forecasters are predicting further rate cuts in the next financial year. The timing and severity of the cuts may be different but the trend is the same. It is difficult to argue against this message as the pressure of a recession in the USA will impact on Europe and our own economy will come under pressure. The Council has already placed as much of it's current portfolio into fixed rate, fixed period deals as it feels it can do within it's current risk spread policy and will adopt a policy of running down it's investments as they mature during 2008/9 whilst waiting for the opportune time to borrow to fund it's long term capital projects. This policy should minimise the impact of falling investment rates.

For its cash flow generated balances, the Council will seek to utilise its business reserve accounts and short-dated deposits (1-3 months) in order to benefit from the compounding of interest.

End of year Investment Report

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

**Appendix D**

## Interest Rate Forecasts

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). The final one represents summarised figures drawn from the population of all major City banks and academic institutions.

The forecast within this strategy statement has been drawn from these diverse sources and officers' own views.

## 1. INDIVIDUAL FORECASTS

**Sector** interest rate forecast – 6 December 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 | 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% |

**Capital Economics** interest rate forecast –18 December 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 |
|---|---|---|---|---|---|---|---|---|
| Bank Rate | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| 5yr PWLB rate | 1.65% | 1.45% | 1.45% | 1.45% | 1.45% | 1.45% | 1.45% | 1.45% |
| 10yr PWLB rate | 2.65% | 2.15% | 2.15% | 2.15% | 2.15% | 2.15% | 2.15% | 2.15% |
| 25yr PWLB rate | 4.15% | 4.00% | 3.80% | 3.65% | 3.65% | 3.65% | 3.65% | 3.65% |
| 50yr PWLB rate | 4.05% | 3.95% | 3.85% | 3.75% | 3.75% | 3.75% | 3.75% | 3.75% |

**UBS** interest rate forecast (for quarter ends) – 12 December 2008

| | Q/E1 2009 | Q/E2 2009 | Q/E3 2009 | Q/E4 2009 |
|---|---|---|---|---|
| Bank rate | 0.50% | 0.50% | 0.50% | 0.75% |
| 10yr PWLB rate | 3.75% | 4.15% | 4.35% | 4.65% |
| 25yr PWLB rate | 4.25% | 4.55% | 4.85% | 5.05% |
| 50yr PWLB rate | 4.30% | 4.65% | 5.00% | 5.25% |

## 2. SURVEY OF ECONOMIC FORECASTS

**HM Treasury** – December 2008 summary of forecasts of 23 City and 12 academic analysts for Q4 2008 and 2009. Forecasts for 2010 – 2012 are based on 21 forecasts in the last quarterly forecast – November 2008.

| BANK RATE FORECASTS | | quarter ended | | annual average Bank Rate | | |
|---|---|---|---|---|---|---|
| | actual | Q4 2008 | Q4 2009 | ave. 2010 | ave. 2011 | ave. 2012 |
| Median | 2.00% | 2.00% | 1.00% | 3.11% | 3.97% | 4.49% |
| Highest | 2.00% | 4.50% | 4.00% | 4.70% | 5.00% | 5.25% |
| Lowest | 2.00% | 2.00% | 0.50% | 1.00% | 2.25% | 3.00% |

## Appendix E

## Central Bank Rate Movements

| | UK | UK | UK | US | EU | UK | US | ECB |
|---|---|---|---|---|---|---|---|---|
| | MPC | MPC Minutes | Inflation Report | FOMC | ECB | Bank Rate | Fed. Rate | Refi Rate |
| **2008** | | | | | | | | |
| Jan | - | - | | 22 | | 5.50% | 3.50% | 4.00% |
| Jan | 9-10 | 23 | | 29-30 | 10 | 5.50% | 3.00% | 4.00% |
| Feb | 6-7 | 20 | 13 | 21 (mins) | 7 | 5.25% | 3.00% | 4.00% |
| Mar | 5-6 | 19 | | 18 | 6 | 5.25% | 2.25% | 4.00% |
| Apr | 9-10 | 23 | | 29-30 | 10 | 5.00% | 2.00% | 4.00% |
| May | 7-8 | 21 | 14 | | 8 | 5.00% | 2.00% | 4.00% |
| Jun | 4-5 | 18 | | 24-25 | 5 | 5.00% | 2.00% | 4.00% |
| Jul | 9-10 | 23 | | | 3 | 5.00% | 2.00% | 4.25% |
| Aug | 6-7 | 20 | 13 | 5 | 7 | 5.00% | 2.00% | 4.25% |
| Sep | 3-4 | 17 | | 16 | 4 | 5.00% | 2.00% | 4.25% |
| Oct | 8-9 | 22 | | 28-29 | 2 | 4.50% | 1.50% | 3.75% |
| Nov | 5-6 | 19 | 12 | | 6 | 3.00% | 1.00% | 3.25% |
| Dec | 3-4 | 17 | | 16 | 4 | 2.00% | 0-0.25% | 2.50% |
| **2009** | | | | | | | | |
| Jan | 7-8 | 21 | | 27-28 (7 mins) | 15 | 1.50% | 0-0.25% | 2.00% |
| Feb | 4-5 | 18 | 11 | | 5 | 1.00% | 0-0.25% | 2.00% |
| Mar | 4-5 | 18 | | 17 | 5 | 0.50% | 0-0.25% | 1.50% |
| Apr | 8-9 | 22 | | 28-29 | 2 | 0.50% | 0-0.25% | 1.25% |
| May | 6-7 | 20 | 13 | | 7 | 0.50% | 0-0.25% | 1.00% |
| Jun | 3-4 | 17 | | 23-24 | 4 | 0.50% | 0-0.25% | 1.00% |
| Jul | 8-9 | 22 | | | 2 | 0.50% | 0-0.25% | 1.00% |
| Aug | 5-6 | 19 | 12 | 11 | 6 | 0.50% | 0-0.25% | 1.00% |
| Sep | 9-10 | 23 | | 22 | 3 | 0.50% | 0-0.25% | 1.00% |
| Oct | 7-8 | 21 | | | 8 | 0.50% | 0-0.25% | 1.00% |
| Nov | 4-5 | 18 | 11 | 3-4 | 5 | 0.50% | 0-0.25% | 1.00% |
| Dec | 9-10 | 23 | | 15 | 3 | 0.50% | 0-0.25% | 1.00% |
| **2010** | | | | | | | | |
| Jan | 6-7 | 20 | | 27 | 14 | 0.50% | 0-0.25% | 1.00% |
| Feb | 3-4 | 17 | 10 | | 4 | 0.50% | 0-0.25% | 1.00% |
| Mar | 3-4 | 17 | | 16 | 4 | 0.50% | 0-0.25% | 1.00% |

**Appendix F**

The following Prudential indicators are relevant for the purposes of setting an integrated treasury management strategy.

| No. | PRUDENTIAL INDICATOR<br>EXTRACT FROM BUDGET | 2008/09<br>Actual<br>£ | 2009/10<br>Original<br>£ | 2009/10<br>Actual<br>£ |
|---|---|---|---|---|
| 7 | **Capital Financing Requirement as at 31 March** | | | |
| | Non - HRA | 62.88 | 79.40 | 60.15 |

| No. | TREASURY MANAGEMENT INDICATORS | 2008/09<br>Actual<br>£ | 2009/10<br>Estimate<br>£ | 2009/10<br>Actual<br>£ |
|---|---|---|---|---|
| 10 | **Authorised Limit for external debt -** | | | |
| | Borrowing | 40.70 | 73.40 | 22.00 |
| | Other Long Term Liabilities | 0.00 | 0.00 | 0.00 |
| | TOTAL | 40.70 | 73.40 | 22.00 |
| 11 | **Operational Boundary for external debt -** | | | |
| | Borrowing | 40.70 | 68.40 | 22.00 |
| | Other Long Term Liabilities | 0.00 | 0.00 | 0.00 |
| | TOTAL | 40.70 | 68.40 | 22.00 |
| 12 | **Upper limit for fixed interest rate exposure** | | | |
| | Expressed as: | | | |
| | Net Principal re Fixed Borrowing / Investments | 20.00<br>(50%) | 51.30<br>(75%) | 3.90<br>(18%) |
| 13 | **Upper limit for variable rate exposure** | | | |
| | Expressed as: | | | |
| | Net Principal re Variable Borrowing / Investments | 20.70 | 51.30 | 2.00 |
| | Net Interest re Variable Rate Borrowing / Investments | (51%) | (75%) | (9%) |
| 14 | **Maturity Structure for New Fixed Rate Borrowing during 2009/10** | Upper | Upper | Upper |
| | Under 12 months | 0% | 50% | 0% |
| | 12 months and within 24 months | 0% | 75% | 0% |
| | 24 months and within 5 years | 0% | 50% | 0% |
| | 5 years and within 10 years | 0% | 50% | 0% |
| | 10 years and above | 0% | 75% | 0% |

| | | | | |
|---|---|---|---|---|
| 15 | **Upper limit for Total Principal Sums invested for over** | **%** | % | % |
| | Up to 1 year (per maturity date) | 78 | 100 | 62 |
| | Up to 2 years (per maturity date) | 22 | 60 | 0 |
| | 2+ years (per maturity date) | 5 | 30 | 0 |

| | |
|---|---|
| 16 | **Maturity Structure of New Fixed Rate Borrowing in Previous year** |
| | None taken in 2009/10 |