

**REPORT TO:** Executive Board  
**DATE:** 12<sup>th</sup> February 2009  
**REPORTING OFFICER:** Operational Director – Financial Services  
**SUBJECT:** Treasury Management and Investment Strategy 2009/10  
**WARD(S):** Borough-wide

## **1.0 PURPOSE OF REPORT**

1.1 To propose the Treasury Management Strategy for 2009/10.

## **2.0 RECOMMENDED that:**

- (1) the Council adopt the policies, strategies and statements outlined in the Treasury Management Strategy; and**
- (2) delegated authority be given to the Operational Director Financial Services to set the Minimum Revenue Provision repayment periods.**

## **3.0 SUPPORTING INFORMATION**

3.1 The Treasury Management Strategy Statement is shown in Appendix A and details the expected activities of the Treasury function in the forthcoming financial year (2009/10). Its production and adoption by Council is a requirement of the CIPFA Code of Practice on Treasury Management.

3.2 The Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

3.3 The Act therefore requires the Council to set out its treasury strategy for borrowing as well as an Investment Strategy; which sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

3.4 A new requirement for 2009/10 is the production of a Minimum Revenue Provision Policy Statement. There is a detailed explanation of why this is required in the Strategy, together with a formal statement for approval.

## **4.0 POLICY IMPLICATIONS**

4.1 The successful delivery of the strategy will assist the Council in

meeting its budget commitments and help deliver all its priorities.

## **5.0 FINANCIAL IMPLICATIONS**

5.1 Over the years the Council's Treasury Management has made a major contribution to balancing the budget. The Council is expecting to borrow significant sums over the next few years and it is opportune that low interest rates currently prevail. Conversely, low rates will result in significant reductions in the Council's investment returns.

## **6.0 IMPLICATIONS FOR THE COUNCIL'S PRIORITIES**

6.1 **Children and Young People in Halton**

6.2 **Employment, Learning and Skills in Halton**

6.3 **A Healthy Halton**

6.4 **A Safer Halton**

6.5 **Halton's Urban Renewal**

## **7.0 RISK ANALYSIS**

7.1 The Authority operates its treasury management activity within the approved code of practice and supporting documents. The aim at all times is to operate in an environment where risk is clearly identified and managed

7.2 This strategy sets out clear objectives within these guidelines. Regular monitoring is undertaken during the year and reported on a quarterly basis to the Executive Board Sub-Committee.

## **8.0 EQUALITY AND DIVERSITY ISSUES**

8.1 None.

## **9.0 REASON(S) FOR DECISION**

9.1 The Authority must have an approved annual strategy in place before the year commences.

## **10.0 ALTERNATIVE OPTIONS CONSIDERED AND REJECTED**

10.1 None.

## **11.0 IMPLEMENTATION DATE**

11.1 1st April 2009.

**12.0 LIST OF BACKGROUND PAPERS UNDER SECTION 100D  
OF THE LOCAL GOVERNMENT ACT 1972**

<b>Document</b>	<b>Place of Inspection</b>	<b>Contact Officer</b>
Working papers	Accountancy Section	J. Viggers

**TREASURY MANAGEMENT STRATEGY 2009/10**

**1.0 INTRODUCTION**

1.1 The Treasury Management Strategy for 2009/10 covers the following aspects of the treasury management function and is based upon the Treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor.

- 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;
- the investment strategy;
- debt rescheduling;
- minimum revenue provision.

**2.0 TREASURY LIMITS FOR 2009/10**

2.1 It is a statutory duty under S.3 of the Local Government Act 2003, and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the "Affordable Borrowing Limit".

2.2 The Council must have regard to the Prudential Code when setting its Affordable Borrowing Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax is 'acceptable'.

2.3 Whilst termed an "Affordable Borrowing Limit", the capital plans to be considered for inclusion incorporate those planned to be financed by both external borrowing and other forms of liability, such as credit arrangements. The affordable borrowing limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.

**3.0 PRUDENTIAL INDICATORS FOR 2009/10-2011/12**

3.1 A requirement of the Prudential Code is that various prudential indicators must be approved by the Council. These are shown in Annex 1 and are relevant for the purposes of setting an integrated treasury management strategy.

#### 4.0 CURRENT PORTFOLIO POSITION

4.1 The Council's treasury portfolio position at 15 January 2009 comprised:

		Principal		Average Rate
		£m	£m	%
Fixed Rate Funding	PWLB	10.00	22.45	3.70
	Market	12.45		3.66
Variable Rate Funding	PWLB	0.00	0.00	-
	Market	0.00		-
Total Borrowing			22.45	3.68
Other Long Term Liabilities			0.00	
Total Debt			22.45	
Total Investments			54.05	5.62

#### 5.0 BORROWING REQUIREMENT

5.1 The table below summarises the net borrowing requirement for the authority for the next three years based on the current level of supported borrowing indicated by the government and prudential borrowing contained in the capital programme.

	2008/09	2009/10	2010/11	2011/12
	£'000	£'000	£'000	£'000
New Borrowing	12,283	12,688	14,916	27,818
Alternative Financing Arrangements	-	-	-	-
Replacement Borrowing*	-	-	-	-
<b>TOTAL</b>	<b>12,283</b>	<b>12,688</b>	<b>14,916</b>	<b>27,818</b>

5.2 The £10m Lender's Option Borrower's Option (LOBO), currently with Euro Hypo bank is on 6 month options As such it could fall to be replaced in any of the years.

5.3 The advanced land acquisition for the Mersey Gateway project is the major factor for the new borrowing. This will significantly increase total debt in the short to medium term.

#### 6.0 PROSPECTS FOR INTEREST RATES

6.1 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. Annex 2 draws together a number of current City forecasts for short term or variable (the base rate or repo rate) and longer fixed interest rates.

## 6.2 Sector View: Interest rate forecast – 6<sup>th</sup> 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 analysis of the economic background is shown in Annex 3 and its 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.

## 7.0 CAPITAL BORROWINGS AND THE BORROWING PORTFOLIO STRATEGY

### 7.1 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.

7.2 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.

7.3 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.

#### **7.4 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.

7.5 Against this volatile background caution will be adopted with the 2009/10 treasury operations. The Operational Director Financial Services 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.

**7.6 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.*

7.7 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.

## **8.0 ANNUAL INVESTMENT STRATEGY**

### **8.1 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.

### **8.2 Specified v non specified investments**

There has been an increasing number of innovative investment products being marketed over the past few years. They 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.

### 8.3 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.

### 8.4 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% 60%	2-3 years 1-2 years
Term deposits – other LAs (with maturities in excess of 1 year)	-	In-house	30% 50%	2-3 years 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% 60%	2-3 years 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.

## 8.5 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. Annex 2 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 its current portfolio into fixed rate, fixed period deals as it feels it can do within its current risk spread policy and will adopt a policy of running down its investments as they mature during 2008/9 whilst waiting for the opportune time to borrow to fund its 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.

#### 8.6 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.

### 9.0 DEBT RESCHEDULING

9.1 The introduction of different PWLB rates on 1 November 2007 for new borrowing as opposed to early repayment of debt, and the setting of a spread between the two rates (of about 40 – 50 basis points for the longest period loans narrowing down to 25 – 30 basis points for the shortest loans), has meant that PWLB to PWLB debt restructuring is now much less attractive than before that date. However, significant interest savings may still be achievable through using LOBOs (Lenders Option Borrowers Option) loans and other market loans if these become available after the drying up of their supply during autumn 2008.

9.2 Due to short term borrowing rates being expected to be considerably cheaper than longer term rates, there are likely to be significant opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of their short term nature and the likely cost of refinancing those short term loans, once they mature, compared to the current rates of longer term debt in the existing debt portfolio. Any such rescheduling and repayment of debt is likely to cause a rebalancing of an authority's debt maturities towards a flattening of the maturity profile as in recent years there has been a skew towards longer dated PWLB.

Consideration will also be given to the potential for making savings by running down investment balances by repaying debt prematurely as short term rates on investments are likely to be lower than rates paid on currently held debt. However, this will need careful consideration in the light of premiums that may be incurred by such a course of action and other financial considerations.

As average PWLB rates in some maturity periods are expected to be minimally higher earlier on in the financial year than later on, there should therefore be greater potential for making marginally higher interest rate savings on debt by doing debt restructuring earlier on in the year. Any positions taken via rescheduling will be in accordance with the strategy position outlined in paragraph 7 above.

- 9.3 The reasons for any rescheduling to take place will include:
- the generation of cash savings and / or discounted cash flow savings;
  - help fulfil the strategy outlined in paragraph 7 above; and
  - enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).
- 9.4 All rescheduling will be reported to the Executive Board Sub-Committee at the meeting following its action.

## **10.0 MINIMUM REVENUE PROVISION**

- 10.1 Capital expenditure is generally expenditure on assets which have a life expectancy of more than one year e.g. buildings, vehicles, machinery etc. It would be impractical to charge the entirety of such expenditure to revenue in the year in which it was incurred and so such expenditure is spread over several years so as to try to match the years over which such assets benefit the local community through their useful life. The manner of spreading these costs is through an annual Minimum Revenue Provision, which was previously determined under Regulation, and will in future be determined under Guidance.

Statutory Instrument 2008 no. 414 s4 lays down that:

“A local authority shall determine for the current financial year an amount of minimum revenue provision that it considers to be prudent.”

The above is a substitution for the previous requirement to comply with regulation 28 in S.I. 2003 no. 3146, (as amended)

- 10.2 Along with the above duty, the Government issued new guidance in February 2008 which requires that a Statement on the Council’s policy for its annual MRP should be submitted to the full Council for approval before the start of the financial year to which the provision will relate.
- 10.3 The Council are legally obliged to “have regard” to the guidance, which is intended to enable a more flexible approach to assessing the amount of annual provision than was required under the previous statutory requirements. The guidance offers four main options under which MRP could be made, with an overriding recommendation that the Council should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits. The requirement to ‘have regard’ to the guidance therefore means that: -
1. Although four main options are recommended in the guidance, there is no intention to be prescriptive by making these the only

methods of charge under which a local authority may consider its MRP to be prudent.

2. It is the responsibility of each authority to decide upon the most appropriate method of making a prudent provision, after having had regard to the guidance.

## 10.4 Options Available

### **Option 1: Regulatory Method**

Under the previous MRP regulations, MRP was set at a uniform rate of 4% of the adjusted CFR (i.e. adjusted for "Adjustment A") on a reducing balance method (which in effect meant that MRP charges would stretch into infinity). This historic approach must continue for all capital expenditure incurred in years before the start of this new approach. It may also be used for new capital expenditure up to the amount which is deemed to be supported through the SCE annual allocation..

### **Option 2: Capital Financing Requirement Method**

This is a variation on option 1 which is based upon a charge of 4% of the aggregate CFR without any adjustment for Adjustment A, or certain other factors which were brought into account under the previous statutory MRP calculation. The CFR is the measure of an authority's outstanding debt liability as depicted by their balance sheet.

### **Option 3: Asset Life Method.**

This method may be applied to most new capital expenditure, including where desired that which may alternatively continue to be treated under options 1 or 2.

Under this option, it is intended that MRP should be spread over the estimated useful life of either an asset created, or other purpose of the expenditure. There are two useful advantages of this option: -

- Longer life assets e.g. freehold land can be charged over a longer period than would arise under options 1 and 2.
- No MRP charges need to be made until the financial year after that in which an item of capital expenditure is fully incurred and, in the case of a new asset, comes into service use (this is often referred to as being an 'MRP holiday'). This is not available under options 1 and 2.

There are two methods of calculating charges under option 3:

- a. equal instalment method – equal annual instalments
- b. annuity method – annual payments gradually increase during the life of the asset

### **Option 4: Depreciation Method**

Under this option, MRP charges are to be linked to the useful life of each type of asset using the standard accounting rules for depreciation

(but with some exceptions) i.e. this is a more complex approach than option 3.

The same conditions apply regarding the date of completion of the new expenditure as apply under option 3.

### **10.5 Date of implementation**

The previous statutory MRP requirements cease to have effect after the 2006/07 financial year. However, the same basis of 4% charge may continue to be used without limit until the 2009/10 financial year, relative to expenditure incurred up to 31/3/2009.

### **10.6 Statement for 2009/10**

The Council will implement the new Minimum Revenue Provision (MRP) guidance in *2008/09*, and assess their MRP for *2008/09* in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003. .

The major proportion of the MRP for 2008/09 will relate to the more historic debt liability that will continue to be charged at the rate of 4%, in accordance with *option 1* of the guidance. Certain expenditure reflected within the debt liability at 31<sup>st</sup> March 2008 will under delegated powers be subject to MRP under *option 3*, which will be charged over a period which is reasonably commensurate with the estimated useful life applicable to the nature of expenditure, using the equal annual instalment method. For example, capital expenditure on a new building, or on the refurbishment or enhancement of a building, will be related to the estimated life of that building.

Estimated life periods will be determined under delegated powers. To the extent that expenditure is not on the creation of an asset and is of a type that is subject to estimated life periods that are referred to in the guidance, these periods will generally be adopted by the Council. However, the Council reserves the right to determine useful life periods and prudent MRP in exceptional circumstances where the recommendations of the guidance would not be appropriate.

As some types of capital expenditure incurred by the Council are not capable of being related to an individual asset, asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure. Also, whatever type of expenditure is involved, it will be grouped together in a manner which reflects the nature of the main component of expenditure and will only be divided up in cases where there are two or more major components with substantially different useful economic lives.

MRP will be charged to revenue on the completion of schemes. This is particularly relevant to schemes that span more than one financial year such as the Mersey Gateway project.



## PRUDENTIAL INDICATORS

	2007/08	2008/09	2009/10	2010/11	2011/12
<b>Affordability</b>					
1. Ratio of financing costs to net revenue stream (estimate) – General Fund %		0.2	2.0	3.0	3.7
2. Ratio of financing costs to net revenue stream (actual) – General Fund %	- 0.6				
3. Incremental impact of capital investment decisions on the Council Tax £		13.66	9.14	10.04	20.29
<b>Capital Expenditure</b>					
5. Total capital expenditure (estimate) (see Note) – General Fund £m Note: These figures will be amended as further allocations and grant approvals are received.		43.6	39.4	30.2	35.2
6. Total capital expenditure (actual) – Actual £m	29.1				
<b>Capital Financing Requirement</b>					
7. Capital Financing Requirement (estimate) – General Fund £m		66.7	79.4	94.3	122.2
8. Capital Financing Requirement (actual) – General Fund £m	54.4				

	2007/08	2008/09	2009/10	2010/11	2011/12
<b>Treasury Management</b>					
Adopted CIPFA Code of Practice for Treasury Management					
9. Authorised limit for external debt		56.0	73.4	103.7	108.7
10. Operational boundary for external debt		51.0	68.4	98.7	103.7
11. External debt (actual)	26.0				
12. Upper limit on interest rate exposure on fixed rate debt			75	75	75
13. Upper limit on interest rate exposure on variable rate debt			75	75	75
14. Maturity structure of borrowing as a percentage of fixed rate borrowing					
Under 12 months			0	50	
12 months - 2 years			0	75	
2 years - 5 years			0	50	
5 years - 10 years			0	50	
10 years and above			0	75	
15. Total principal sums invested for periods longer than 364 days					
1-2 years			60	60	60
2-3 years			30	30	30
16. Maturity Structure of new fixed rate borrowing in previous year	None				

## 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%

**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 8<sup>th</sup> 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 8<sup>th</sup> October. The Fed subsequently cut rates again by 50bp to 1% on 29<sup>th</sup> 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 4<sup>th</sup> November the USA elected Barack Obama as President with little immediate financial impact.

The ECB reduced rates again on 6<sup>th</sup> 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 3<sup>rd</sup> and 4<sup>th</sup> 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.