AGENDA ITEM: 5 Page nos. 19 – 33

Meeting	Cabinet Resources
Date	17 March 2005
Subject	**Treasury Management**
Report of	Cabinet Member for Resources
Summary	To approve the Treasury Management Strategy and Annual Investment Strategy for 2005/06.

Officer Contributors	Borough Treasurers
Status (public or exempt)	Public
Wards affected	Not applicable
Enclosures	Appendix A: Treasury Management Strategy Statement and Annual Investment Strategy Appendix B: Interest Rate Forecasts
For decision by	Cabinet Resources Committee
Function of	Executive
Reason for urgency / exemption from call-in (if appropriate)	Not applicable

Contact for further information: Patrick Towey 0208 359 7119

1. RECOMMENDATIONS

1.1 That the Treasury Management and Annual Investment Strategy for 2005/06 be approved.

2. RELEVANT PREVIOUS DECISIONS

2.1 Cabinet Resources 22 April 22 April 2004

3. CORPORATE PRIORITIES AND POLICY CONSIDERATIONS

3.1 In order for the Council to be able to deliver effective services within the Council's policy framework to members of the public it is necessary to have a sound financial base.

4. RISK MANAGEMENT ISSUES

4.1 N/A.

5. FINANCIAL, STAFFING, ICT AND PROPERTY IMPLICATIONS

5.1 One of the prime objectives of CIPFA's Code of Practice on Treasury Management and subsequent Treasury Policy Statements is to ensure that, by using prudent and proper practices, the financial resources of local authorities are protected and best used.

6. LEGAL ISSUES

6.1 Referred to elsewhere in the report.

7. CONSTITUTIONAL POWERS

7.1 The Borough Treasurer has delegated powers to take the most appropriate form of borrowing from the approved sources, and to make the most appropriate form of investments in approved instruments.

8. BACKGROUND INFORMATION

8.1 General power to borrow for both revenue and capital purposes is contained in Section 3 of the Local Government Act 2003.

8.2 Powers to authorise investments are contained in Section 15(1) (a) of the Local Government Act 2003.

8.3 The Council's policy is to operate within the legal constraints.

8.4 Treasury Strategy Statement 2005/06.

8.5 The Chartered Institute of Public Finance and Accountancy (CIPFA) issued a revised edition of the Treasury Management in the Public Services Code of Practice in 2002.

8.6 This code was adopted by the Council on 7 January 2003.

9. LIST OF BACKGROUND PAPERS

9.1 Treasury Management in the Public Services – CIPFA's Code of Practice and Cross-Sectoral Notes.

BS: JEL
BT: CM

APPENDIX A
Treasury Strategy Statement

1 Introduction

1.1.1 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.

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

The ODPM's investment guidance was issued too late for the Annual Investment Strategy to be included in the Treasury Strategy Statement for 2004/05. However, the guidance did state that in future years, authorities could combine the Treasury Strategy Statement and Annual Investment Strategy into one report; the Council has adopted that suggestion and the Annual Investment Strategy is therefore included in paragraph 9.

1.2.1 The suggested strategy for 2005/06 in respect of the following aspects of the treasury management function is based upon the Treasury Officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor, Sector Treasury Services Limited.
The strategy covers:

- treasury limits in force which will limit the treasury risk and activities of the Council;
- Prudential Indicators;
- the current treasury position;
- the borrowing requirement;
- prospects for interest rates;
- debt rescheduling;
- the borrowing strategy;
- the investment strategy;
- further discussions with Barnet Homes on their capital programme may alter the borrowing strategy.

2 Treasury Limits for 2005/06 to 2007/08

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. In England and Wales the authorised limit is the legislative limit for borrowing as designated by the aforementioned act.

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

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

3 Prudential Indicators for 2005/06 – 2007/08

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

The Council is also required to indicate if it has adopted the CIPFA code of Practice on Treasury Management. This was adopted on 7 January 2003 by the full Council.

PRUDENTIAL INDICATOR	2003/04	2004/05	2005/06	2006/07	2007/08
(1). EXTRACT FROM BUDGET AND RENT SETTING REPORT					
	actual	**probable outturn**	**estimate**	**estimate**	**estimate**
Capital Expenditure	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
Non - HRA	40,595	47,155	62,642	28,427	18,446
HRA (applies only to housing authorities)	11,947	18,311	28,668	27,679	29,628
TOTAL	52,542	65,466	91,310	56,106	48,074
Ratio of financing costs to net revenue stream					
Non - HRA	0.37%	0.53%	1.44%	1.83%	2.13%
HRA (applies only to housing authorities)	23%	39%	40%	41%	42%
Net borrowing requirement	£'000	£'000	£'000	£'000	£'000
brought forward 1 April	27,209	28,500	95,860	149,393	166,988
carried forward 31 March	36,100	12,792	23,800	28,560	34,270
in year borrowing requirement	-8,891	15,708	72,060	120,833	132,718
In year Capital Financing Requirement					
Non - HRA	48,548	15,007	29,770	12,457	2,379
HRA (applies only to housing authorities)	0	6,678	17,977	18,957	15,216
TOTAL	48,548	21,685	47,747	31,414	17,595
Capital Financing Requirement as at 31 March					
Non - HRA	48,548	63,555	93,325	105,782	108,161
HRA (applies only to housing authorities)	0	6,678	24,655	43,612	58,828
TOTAL	48,548	70,233	117,980	149,394	166,989

PRUDENTIAL INDICATOR	2003/04	2004/05	2005/06	2006/07	2007/08
(2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
	actual	probable outturn	estimate	estimate	estimate
Authorised limit for external debt -					
borrowing	53,548	98,497	148,777	181,446	194,713
other long term liabilities	10,000	15,000	25,000	35,000	45,000
TOTAL	63,548	113,497	173,777	216,446	239,713
Operational boundary for external debt -					
borrowing	48,548	62,000	110,000	142,000	160,000
other long term liabilities	5,000	5,000	10,000	20,000	20,000
TOTAL	53,548	67,000	120,000	162,000	180,000
Upper limit for fixed interest rate exposure					
Net principal re fixed rate borrowing / investments:-	100%	100%	100%	100%	100%
Upper limit for variable rate exposure					
Net principal re variable rate borrowing / investments:-	30%	30%	30%	30%	30%

Maturity structure of fixed rate borrowing during 2005/06	upper limit	lower limit
under 12 months	70%	0%
12 months and within 24 months	25%	0%
24 months and within 5 years	30%	0%
5 years and within 10 years	75%	15%
10 years and above	95%	25%

4. Current Portfolio Position

The Council's treasury portfolio position at 31/12/04 comprised:

		Principal		Ave. rate
		£m		%
Fixed rate funding	PWLB	19		
	Market	9.5	28.5	4.32
Variable rate funding	PWLB	0		
	Market	0	0	0
Other long term liabilities			0	
TOTAL DEBT			**28.5**	**4.32**
TOTAL INVESTMENTS			58.8	**4.78**

The Council redeemed £30m PWLB debt at the end of the last financial year, and was debt free at 31March 2004. By becoming debt free the Council was able to qualify for a transitional reduction in the payment of HRA capital receipts into the national pool. It was also able to apportion the premia costs from the debt redemption between the general fund and the housing revenue account; if the debt was repaid after 2003/04 then HRA set-aside receipts arising from Right to Buy sales would have resulted in 100% of the premia falling on the general fund.

5. Long-term Borrowing Requirement

	2003/04	2004/05	2005/06	2006/07	2007/08
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
	Actual	**Probable**	**Estimate**	**Estimate**	**Estimate**
New borrowing	**48,548**	**21,685**	**47,747**	**31,414**	**17,595**
Alternative financing arrangements					
Replacement borrowing					
TOTAL	**48,548**	**21,685**	**47,747**	**31,414**	**17,595**

The borrowing requirement is the underlying need to borrow for capital purposes, the capital financing requirement, and is not the actual level of borrowing the Council has on its books.

6. Prospects for Interest Rates

The Council has appointed Sector Treasury Services as treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. Appendix B 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 Sector central view.

Sector View: Interest rate forecast – January 2005

	Q/E1 2005	Q/E2 2005	Q/E3 2005	Q/E4 2005	Q/E1 2006	Q/E2 2006	Q/E3 2006	Q/E4 2006	Q/E1 2007	Q/E2 2007	Q/E3 2007
Base Rate	5.00%	5.00%	4.75%	4.75%	4.50%	4.50%	4.25%	4.25%	4.25%	4.50%	4.50%
5 yr Gilt Yield	4.75%	4.75%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.75%	4.75%
10 yr PWLB Rate	5.00%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%
25 yr PWLB Rate	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%

Economic background

UK

- Economic data currently indicates GDP above previously forecasted trend; however there are indications of weakening activity ahead.
- Slowdown in household spending and weakening housing market.
- Benign inflation at present may rise in 2005 as high street competition cannot sustain the current situation against the effect of rising oil prices.
- Sterling expected to remain at $1.80 or above.

International

- US - measured interest rate raising by the Federal Reserve; weak trend employment data.
- Consumer slowdown shows no signs of abating and this will be compounded by high oil prices, rising interest rates, the fading effects of past tax cuts and a faltering labour market.
- US inflation benign.

- ECB has held repo rate at 2.00% since June 2003.
- Weak domestic demand/export led growth indicates an economy about to suffer as world economy expected to slow.

Interest rate forecast

- The base rate is expected to rise to 5.00% in Q1 2005, but is nearing the peak of the cycle, and is consequently expected to fall back in 2005.

Long term 25 year PWLB rate:

- Expected to remain around 4.75%
  - Housing market to weaken from fast market increases causing consumers to feel the pinch.
  - Slower global growth driven by weakness in the US.

7. Borrowing Strategy

It is considered unlikely that there will be much difference between short-term variable PWLB rates and medium and long-term PWLB fixed rate borrowing during 2005/06 provided the base rate falls from 5.0% to 4.75% as expected in quarter 3 of 2005. Variable rate borrowing will therefore be slightly more expensive than long term fixed borrowing during quarter 2, but is expected to become cheaper in quarter 1 of 2006 when base rate is forecast to fall to 4.5%.

Thereafter variable rate borrowing is expected to become still cheaper during 2006 and so the gap will widen further between long-term fixed and variable rates (see table in section 6).

Long-term rates are not currently expected to move significantly in 2005/06 but may drift to the downside.

These interest rate expectations provide a variety of options:

- that short-term variable rates will be good value compared to long-term rates, and are likely to remain so for potentially at least the next couple of years. Best value will therefore be achieved by borrowing short term at variable rates in order to minimise borrowing costs in the short term or to make short-term savings in order to meet budgetary constraints. If fixed PWLB rates should fall significantly, then a suitable trigger point for considering new fixed rate long term borrowing would be about 4.5%.
- that the risks intrinsic in the shorter term variable rates are such, that when compared to historically relatively low long term fixed funding which may be achievable in 2005/06, the Council will maintain a stable, longer term portfolio by drawing longer term fixed rate funding at a marginally higher rate than short term rates.

The generation of large capital receipts would provide the authority with a further option as these receipts could be used to redeem some of the Council's debt or restructure its maturity profile. Alternatively these receipts could be made available for investment purposes rather than spending.
Against this background caution will be adopted with the 2005/06 treasury operations. The Borough Treasurer will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to cabinet at the next available opportunity.

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 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, 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 remaining low or weakening, then long term borrowings will be postponed, and any rescheduling from fixed rate funding into variable or short rate funding will be exercised.

8. Debt Rescheduling

Opportunities may exist for restructuring long term debt into short term variable rate debt to produce savings later in the year, particularly once base rate has fallen to 4.5%. With variable rate borrowing rates likely to fall significantly during 2005/06, it will be best to avoid restructuring into fixed borrowing for short periods (e.g. one year). Long term fixed rates are not expected to rise back above 5.25% during 2005/06. Consequently long term debt rates at or above 4.90% would warrant reviewing the potential for undertaking debt restructuring. Any positions taken via rescheduling will be in accordance with the strategy position outlined in paragraph 7 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 paragraph 7 above; and

- In order to enhance the balance of the long term portfolio (amend the maturity profile and/or the balance of volatility).

All rescheduling will be reported to the cabinet, at the meeting following its action.

9. ANNUAL INVESTMENT STRATEGY

9.1 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 the security of capital and 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 categorised as 'Specified' and 'Non-Specified' Investments. This Council only invests in Specified Investments. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

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)

	Minimum 'High' Credit Criteria	**Use**
Debt Management Agency Deposit Facility	Government backed	In-house
Term deposits – UK government	Government backed	In-house
Term deposits – other LAs	High Security although LAs not credit rated.	In-house
Term deposits – banks and building societies	Short-term F1, Long-term AAA to A, Individual A/B, Support 3 Top 15 Building Societies (as defined by Butlers Building Society Guide).	In-house and fund managers
Certificates of deposits issued by banks and building societies	Short-term F1, Long-term AAA to A, Individual A/B, Support 3 Top 15 Building Societies (as defined by Butlers Building Society Guide).	fund managers
Money Market Funds	AAA	
UK Government Gilts	AAA	Fund Managers
Gilt Funds and Bond Funds	Government backed	Fund Managers
Treasury Bills	Government backed	Fund Managers

The Council uses Fitch ratings to derive its criteria. Where a counter-party does not have a Fitch rating, the equivalent Moody's *(or other rating agency if applicable)* rating will be used. All credit ratings will be monitored monthly; the Council is alerted to changes in Fitch ratings through its use of the Sector creditworthiness service. If a downgrade results in the counter-party/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

9.2 Investment Strategy

The Council's in-house funds are mainly cash flow derived. Investments will accordingly be made with reference to cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). In order to spread risk and actively manage its investments the Council uses a matrix to set an upper limit on the amount of funds which may be invested with any one authorised counterparty.

Interest Rate Outlook : Sector is forecasting base rates to be on a falling trend from 5.00% in Q1 and Q2 2005 to 4.50% in Q1 & 2 of 2006. The Council will therefore seek to lock in longer period investments at higher rates before this fall starts for some element of its investment portfolio which represents its core balances.

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.

10. Other Issues

APPENDIX B

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 View interest rate forecast – January 2005

	Q/E1 2005	Q/E2 2005	Q/E3 2005	Q/E4 2005	Q/E1 2006	Q/E2 2006	Q/E3 2006	Q/E4 2006	Q/E1 2007	Q/E2 2007	Q/E3 2007
Base Rate	5.00%	5.00%	4.75%	4.75%	4.50%	4.50%	4.25%	4.25%	4.25%	4.50%	4.50%
5 yr Gilt Yield	4.75%	4.75%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.75%	4.75%
10 yr PWLB Rate	5.00%	4.75%	4.75%	4.75%	4.50%	4.50%	4.50%	4.50%	4.75%	4.75%	4.75%
25 yr PWLB Rate	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%	4.75%

UBS Economic interest rate forecast (for quarter ends) - January 2005

	Q/E1 2005	Q/E2 2005	Q/E3 2005	Q/E4 2005	Q/E1 2006	Q/E2 2006	Q/E3 2006	Q/E4 2006
Base Rate	4.75%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
10 yr PWLB rate	4.70%	4.60%	4.65%	4.70%	4.70%	4.70%	4.70%	4.70%
25 yr PWLB rate	4.55%	4.55%	4.60%	4.65%	4.65%	4.65%	4.65%	4.65%

Capital Economics interest rate forecast – January 2005

	Q/E1 2005	Q/E2 2005	Q/E3 2005	Q/E4 2005	Q/E1 2006	Q/E2 2006	Q/E3 2006	Q/E4 2006
Base Rate	4.75%	4.50%	4.25%	4.00%	3.75%	3.50%	3.50%	3.50%
5yr gilt yield	4.40%	4.30%	4.20%	4.00%	3.80%	3.60%	3.70%	3.80%

10 yr PWLB rate	4.55%	4.45%	4.45%	4.35%	4.25%	4.15%	4.25%	4.35%
25 yr PWLB rate	4.50%	4.40%	4.50%	4.45%	4.50%	4.50%	4.55%	4.55%

2. SURVEY OF ECONOMIC FORECASTS

HM Treasury – 19.01.2005 summary of forecasts of 25 City and 14 academic analysts for Q4 2004 and 2005. (2006 – 2008 are as at November 2004 but are based on 11 forecasts)

	Repo	Quarter ended		annual average repo rate		
		Q4 2004	Q4 2005	ave. 2006	ave. 2007	ave. 2008
Indep. forecasters BoE Base Rate	4.75%	4.77%	4.71%	4.81%	4.82%	4.76%
Highest base rate	4.75%	5.00%	5.25%	5.50%	5.25%	5.25%
Lowest base rate	4.75%	4.75%	3.90%	4.10%	4.10%	3.80%