Agenda Item No. 5

Note:

It is important to note that the Treasury Strategy Statement is adopted by the Council, based upon advice from its external Treasury advisors, and accordingly the Strategy is tailored to meet the specific and unique needs of the Council. All financial information contained within this Report and Statement should not be used by any individual or organisation as a basis for making investment or borrowing decisions. The Council and its Treasury advisors will not accept any liability on behalf of any individual or organisation who seeks to act on the financial information contained within this Report and Statement.

Audit Committee – 12th February 2009

Report of the Director of Finance

Treasury Management

Purpose of Report

1. The purpose of this report is:

   - to outline treasury activity in the year 2008/9 up to the end of December;
   - to seek approval of the Treasury Strategy Statement 2009/10.

Background

2. The Council undertakes treasury management activity on its own behalf and as administering authority for the West Midlands Debt Administration Fund *(WMDAF)*. We are responsible for administering capital funding of approximately £326m on our own account and another £220m on behalf of the WMDAF. The treasury function is governed by the Council's Treasury Policy Statement and Treasury Management Practices.

Treasury activity 2008/9 - Dudley fund

3. Our borrowing and investment activities in the current year have been undertaken in the context of unprecedented market turmoil – the credit crunch, the banking crisis and volatility in the rate of inflation with the economy as a whole moving from slow growth into recession. The Bank of England rate, having stood at 5% from April to October of 2008, has been repeatedly reduced to now stand at only 1.5%. The rate for a 50-year loan from the Public Works Loan Board (PWLB) has been less volatile but has nevertheless fluctuated between 4.82% and 3.86%.

4. During August 2008, having considered medium-term cash flow forecasts and having consulted with our advisors at Sector Treasury Services Limited, we borrowed £30 million from the Public Works Loan Board (PWLB) due to be repaid between 2052 and 2057 at rates ranging from 4.43% to 4.45%.

5. The performance of our investments is largely dependent on movements in short-term *(up to one year)* rates. Prior to the recent and well-publicised falls in interest rates, we were able to take a number of opportunities to invest funds for periods of six months or more at relatively high rates of interest. As a result of these and our other investment activities, our latest forecast for the average return on our investments for the year 2008/9 is 5.1%. The average 7-day LIBID[1] for the financial year to mid-January has been only 4.4% and will fall further by the year end.

6. The returns outlined above have been achieved without compromising on the security of the Council's investments. We have maintained and continue to maintain an approved investment list that sets the highest rating standards. For that reason we have never invested with Northern Rock or the Icelandic Banks. However, it is becoming more difficult to find counterparties where investments can be made for a reasonable return. During the year we opened an account with the Government's Debt Management Office which provides maximum security but low returns. We are only using this account where we cannot place funds with a bank that meets our strict criteria.

7. On 2nd February 2009, following advice from Sector Treasury Services Limited and in the light of the extreme movements in interest rates, we used a portion of our investments to make early repayment of £22.5 million of PWLB loans. These loans were originally due to mature between 2038 and 2056 and were at rates ranging from 4.1% to 4.875%. Given that investments are typically earning between 1% and 2% and that the transaction incurred only a small net premium, this early repayment generates net savings for our treasury operation.

Treasury activity 2008/9 - WMDAF

8. Our borrowing activities in 2005/6 placed us in a position where it was not necessary to undertake any new longer-term borrowing in 2006/7 or 2007/8 or in the current year to date. We anticipate that we will need to take £1m of longer-term borrowing in March 2009 in order to manage cash flow. Having consulted with our advisors at Sector Treasury Services, we did not identify any opportunities to improve our position by restructuring of debt. The latest estimate of interest payable by members of the WMDAF in 2008/9 is 6.7%.

Treasury Strategy Statement 2009/10

9. The Treasury Strategy Statement covers our latest capital funding requirements, our view of interest rate movements and our strategy for borrowing and investment in the light of that view. As such, it needs to be reviewed annually. The Treasury Strategy Statement for 2009/10 is attached as **Appendix 1**.

[1] 7-day LIBID is a measure of the average return from a 7-day investment on the London money market.

10. Our expectations for interest rates over the next twelve months, which are the best prediction we can make in very uncertain market conditions and which will be subject to continuous review with our treasury advisors, are as follows:

- **Short-term rates.** The Bank Rate will fall to 0.5% early in 2009 and remain at that level through 2009/10.
- **Long-term rates.** The 25-year PWLB rate will be around 4% through 2009/10.
- **Very long-term rates**. The 50-year PWLB rate will be around 3.8% through 2009/10.

11. The Local Government Act 2003 introduced a system of "prudential borrowing" allowing councils to set their own borrowing limits subject to criteria of prudence and affordability. These criteria are set out in more detail in the CIPFA Prudential Code which specifically requires us to set a number of prudential indicators. The full range of prudential indicators were considered by the Cabinet on 11th February 2009. The proposed indicators that relate to treasury management are set out in the Treasury Strategy Statement.

12. Councils' investment activities are regulated by government guidance issued under Section 15(1)(a) of the Local Government Act 2003. Section 5 of the Treasury Strategy Statement constitutes an "Annual Investment Strategy" produced in accordance with the government guidance. This Strategy increases the maximum proportion of our investments that we can place with a single institution from 15% to 20%. It also allows for us to make use of investment schemes that invest in non-UK governments where these have the highest (AAA) credit rating and to invest in banks that are wholly-owned by the UK Government. These changes will facilitate our investment activities without compromising on the security of our investments.

13. In order to protect the Council's position if an individual or organisation were to act upon the views expressed in this report, we have deemed it necessary to produce a disclaimer which is shown as a note at the head of the report and Appendix.

Finance

14. Forecasts of performance against budget for treasury management activities are highly sensitive to movements in cash flow and interest rates. Budgets were amended in September to reflect a surplus of £1m compared to the original budget for 2008/9. This amendment was based on prudent assumptions and the final outturn is expected to improve beyond this position.

Law

15. These matters are governed by Part IV of the Local Government and Housing Act 1989 and Section 111 of the Local Government Act 1972, which empowers the Council to do anything which is calculated to facilitate or is conducive or incidental to the discharge of its various statutory functions.

<u>Equality Impact</u>

16. The treasury management activities considered in this report have no direct impact on issues of equality.

<u>Recommendation</u>

17. That the Committee:

- note the treasury activities in 2008/9 outlined in this report;
- approve the Treasury Strategy 2009/10 attached as Appendix 1;
- authorise the Director of Finance to effect such borrowings, repayments and investments as are appropriate and consistent with the approved Treasury Strategy and relevant guidance;
- refer the above for approval by full Council.

…………………………………………..
Mike Williams
Director of Finance

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List of Background Papers

- Treasury Policy Statement, Treasury Management Practices and Schedules to the Treasury Management Practices.
- The Local Government Act 2003
- The Prudential Code for Capital Finance in Local Authorities (CIPFA)
- Guidance on Local Government Investments Issued by the Secretary of State under section 15(1)(a) of the Local Government Act 2003
- Code of Practice for Treasury Management in the Public Services (CIPFA)

Appendix 1

Note:

It is important to note that the Treasury Strategy Statement is adopted by the Council, based on advice from its external Treasury advisors, and accordingly the Strategy is tailored to meet the specific and unique needs of the Council. All financial information contained within this Report and Statement should not be used by any individual or organisation as a basis for making investment or borrowing decisions. The Council and its Treasury advisors will not accept any liability on behalf of any individual or organisation who seeks to act on the financial information contained within this Report and Statement.

DUDLEY METROPOLITAN BOROUGH COUNCIL
TREASURY STRATEGY STATEMENT 2009/10

1.0 INTRODUCTION

1.1 This Treasury Strategy Statement details the expected activities of the treasury function in the financial year 2009/10. The suggested strategy is based upon officers' views of interest rates as advised by external advisors, supplemented with leading market forecasts. The strategy covers:

- the current portfolio position
- prudential indicators
- prospects for interest rates
- temporary investment strategy
- requirements and strategy for long-term borrowing
- debt rescheduling and premature repayment opportunities

2.0 CURRENT PORTFOLIO POSITION

2.1 The Council's estimated debt position as at 1st April 2009 is as follows:

	£m
Long-term debt:	
- PWLB fixed rate	195.8
- Market fixed rate	6.8
- Market LOBO[2]	10.0
Short-term debt	0.2
Total debt	212.8

2.2 The average rate of interest on the above debt is expected to be 5.5%.

2.3 The average level of investments held by the Council during 2008/9 to the end of December was £75m. Action was taken early in February 2009 to reduce our

[2] Lenders Option Borrowers Option (LOBO). This loan is at a fixed rate of 4.6% until February 2009 after which the rate may be varied at the lender's option. If the lender exercises this option to vary the rate then we, as the borrower, have the option to repay the loan.

level of investments in the light of very low interest rates. At this stage, there is no immediate need for borrowing. We will monitor cash flow regularly in order to ascertain when further borrowing is required.

2.4 The Council also administers the debt of the former West Midlands County Council on behalf of the West Midlands districts. The estimated debt position at 1st April 2009 is as follows:

	£m
Long-term debt:	
- PWLB fixed rate	202.8
- Market fixed rate	6.8
- Market LOBO[3]	10.0
Short-term debt	0
Total debt	219.6

2.5 The average rate of interest charged to the West Midlands fund is expected to be 6.7%.

3.0 PRUDENTIAL INDICATORS

3.1 The 2003 Prudential Code for Capital Finance in local authorities requires the Council to set a number of prudential indicators, certain of which replace the borrowing/variable interest limits previously determined as part of the strategy statement, whilst also extending the period covered from one to three years.

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

External debt

These indicators are intended to ensure that levels of external borrowing are affordable, prudent and sustainable. The authorised limit for external debt is a statutory limit (section 3 of the Local Government Act 2003) that should not be breached under any circumstances. It has been calculated to take account of the Council's capital expenditure and financing plans and allowing for the possibility of unusual cash movements. The operational boundary for external debt has also been calculated with regard to the Council's capital expenditure and financing plans allowing for the most likely, prudent, but not worst case scenario for cash flow. Temporary breaches of the operational boundary, due to variations in cash flow, will not be regarded as significant. Actual external debt represents the closing balance for borrowing and other long-term liabilities.

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[3] Lenders Option Borrowers Option (LOBO). This loan is at a fixed rate of 4.6% until February 2007 after which the rate may be varied at the lender's option. If the lender exercises this option to vary the rate then we, as the borrower, have the option to repay the loan.

	2007/08	2008/09	2009/10 Revised	2010/11 Revised	2011/12
	£m	£m	£m	£m	£m
Authorised limit for external debt:					
Borrowing	n/a	590	651	656	657
Other long term liabilities	n/a	6	4	5	6
Total	**n/a**	**596**	**655**	**661**	**663**
Operational boundary:					
Borrowing	n/a	518	589	597	597
other long term liabilities	n/a	6	4	5	6
Total	**n/a**	**524**	**593**	**602**	**603**
Actual External Debt:					
Borrowing	434.8	n/a	n/a	n/a	n/a
Other long term liabilities	1.5	n/a	n/a	n/a	n/a
Total	**436.3**	**n/a**	**n/a**	**n/a**	**n/a**

CIPFA Code of Practice for Treasury Management in the Public Services

The Council adopted the CIPFA Code of Practice for Treasury Management in the Public Services in March 2002.

Interest rate exposures

These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. The upper limit for fixed interest reflects the fact that it is possible to construct a prudent treasury strategy on the basis of using only fixed rate debt and investments, so long as the maturity dates of these debts and investments are reasonably spread. The same does not apply to variable rates where a 100% exposure could lead to significant year on year fluctuations in the cost of debt. The upper limit for variable rate exposure allows for the use of variable rate debt to offset our exposure to changes in short-term rates on our portfolio of investments. This limit reduces over time as our strategy is to gradually reduce our level of investments.

	2008/09	2009/10	2010/11 Revised	2011/12
Upper limit for fixed interest rate exposure	100	100	100	100
Upper limit for variable rate exposure	15	15	10	10

Maturity structure of borrowing and investments

The purpose of the prudential limits for principal sums invested for periods longer than 364 days is to contain the Council's exposure to the possibility of loss that might arise as a result of having to seek early repayment of principal sums invested. On the basis of prudent treasury management the proposed upper limit on principal maturing in any one year for sums invested for over 364 days is £15m.

The maturity structure of fixed rate borrowing is designed to protect against excessive exposures to interest rate changes in any one period, in particular in the course of the next ten years.

Maturity structure of fixed rate borrowing	**Upper limit %**	**Lower limit %**
under 12 months	10	0
12 months and within 24 months	10	0
24 months and within 5 years	15	0
5 years and within 10 years	25	0
10 years and above	100	40

4.0 PROSPECTS FOR INTEREST RATES

4.1 The Council has appointed Sector Treasury Services as its main treasury advisor and has made use of their services in formulating a view on interest rates. Sector has in turn drawn upon the work of a number of City economic forecasters.

Background

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 commodity prices. The European Central Bank (ECB) was more concerned about rising inflation and less so about the state of the economy.
- In the second and third quarters of the year the extent of losses on sub-prime loans and their impact on institutions that had invested in them became increasingly apparent.
- During the autumn we saw the failure of the US investment bank, Lehman brothers and the collapse into receivership of the Icelandic banks. We also saw the rescue by the US Government of Fannie Mae and Freddie Mac (the mortgage banks) and AIG (the insurance giant) and subsequent rescues of a number of banks and financial institutions by governments around the world.
- The financial crisis precipitated an economic crisis with repeated and significant rate cuts by central banks the world over. In an attempt to stave off recession. By 16th December 2008, the US Federal Reserve had

reduced rates to a band of 0.0% to 0.25%. By 15th January 2009 the ECB had reduced its rate to 2%.

UK

- Earlier in 2008 GDP growth 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 with forecasts of 2 million unemployed by the end of the financial year and continuing to increase thereafter through 2010.
- Wage inflation remained relatively subdued as the Government kept a firm lid on public sector pay and private sector wage growth was kept in check by the slowing economy.
- Bank lending came to a virtual standstill in the autumn as the credit crunch tightened. 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.
- 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.
- UK 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 Bank Rate stood at 5% from April to October 2008, reflecting concerns about inflation, which had been rising sharply on the back of higher commodity and food prices. 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. Further repeated and significant cuts brought the Bank Rate to 1.5% by 8th January 2009.
- The difference between the Bank Rate and the London Inter Bank Offer Rate (the rate at which banks will lend to one another) has been a feature, and a concern, of 2008/9. This has eroded the Bank of England's power over monetary policy. However, the power of the Government over the semi nationalised clearing banks has had some impact in enforcing reductions in borrowing rates.
- 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.

4.2 We have arrived at the following view of the prospects for interest rates over the next twelve months:

- **Short-term rates.** The Bank Rate will fall to 0.5% early in 2009 and remain at that level through 2009/10.
- **Long-term rates.** The 25-year PWLB rate will be around 4% through 2009/10.
- **Very long-term rates**. The 50-year PWLB rate will be around 3.8% through 2009/10.

4.3 Our overall strategy will be based on the projections above. However, we will maintain flexibility to take account of unexpected variations from our forecast.

5.0 ANNUAL INVESTMENT STRATEGY

5.1 Our investment activities are subject to government guidance issued under Section 15(1)(a) of the Local Government Act 2003. This section of the Treasury Strategy Statement constitutes an "Annual Investment Strategy" produced in accordance with the guidance.

5.2 In making investment decisions, our priorities will be security of council funds and liquidity. We will pursue the best possible return on our investments, but only to the extent that this is consistent with very low levels of risk in terms of security and liquidity.

5.3 *Strategy for "specified investments"*

5.3.1 The Council will make use of specified investments (as defined within the terms of the government guidance). These are investments that satisfy the following conditions:

a) The investment is denominated in sterling and any payments or repayments in respect of the investment are payable only in sterling.
b) The Council may require that the investment be repaid or redeemed within 12 months of the date on which the investment was made.
c) The making of the investment is not defined as capital expenditure by virtue of regulation 25(1)(d) of the Local Authorities (Capital Finance and Accounting)(England) Regulations 2003.
d) The investment satisfies *either* of the following conditions:
    I. The investment is made with the UK government, a local authority, a parish council or a community council.
    II. The investment is made with a body or in an investment scheme which has been awarded a "high credit rating" by a credit rating agency.

5.3.2 For the purposes of this strategy we define a "high credit rating" as follows (credit ratings taken from Fitch IBCA):

- UK banks and building societies – short-term rating F1+ and support rating of 1 or 2.

- Foreign banks – short-term rating F1+ and support rating of 1.
- An investment scheme investing in (non-UK) government paper with a long-term rating of AAA.

5.3.3 We will monitor credit ratings constantly through the receipt of credit rating bulletins from our treasury management consultants at Sector Treasury Services. Institutions that cease to meet the criteria above will immediately cease to be treated as specified investments.

5.4 *Strategy for "non-specified investments"*

5.4.1 Non-specified investments are those that do not meet the criteria in 5.3.1 above.

5.4.2 In determining which categories of non-specified investments may prudently be used, we will take account of:

- Advice from our treasury management consultants at Sector Treasury Services and Arlingclose.
- The views of experts at other councils.
- To the extent that investments are for a duration of 12 months or more, long-term credit ratings as determined by Fitch IBCA.

5.4.3 We have so far identified the following categories of investment as prudent for use. The table also shows a maximum proportion of our pool of investments that may be held in any one category:

Category of investment	**Maximum for this category of investments as a proportion of total investments (at the time of making a new investment)**
Sterling-denominated euro-sterling bonds issued by supra-national institutions with a long-term credit rating of AAA.	25%
Investments (up to three months) in banks or other financial institutions that are wholly-owned by the UK Government	25%

5.5 *Liquidity of investments*

5.5.1 In determining the maximum period for which investments may be held, we will have regard to our most recent cash-flow forecast. We will not enter into an investment where our cash-flow forecast indicates that, as a result of that investment, we would be forced to borrow money in a future year that we would not otherwise have had to borrow.

5.5.2 We will ensure that, at the time of making a new investment, long-term investments (investments of one year’s duration or more) constitute no more than 50% of our total pool of investments.

5.6 Limit on investments with a single institution

5.6.1 Investments with a single institution or group of banks should not exceed 20% of our total pool of investments or £5million (whichever is greater).

6.0 REQUIREMENTS AND STRATEGY FOR LONG-TERM BORROWING

6.1 The primary factor in determining whether we undertake new long-term borrowing will be cash flow need. We may elect to borrow one or two years in advance of anticipated need if we judge that this is necessary in order to avoid being forced to borrow at higher rates at a later date.

6.2 Our interest rate expectations (outlined in 4.2) 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.

- that the risks intrinsic in the shorter term variable rates are such, when compared to historically relatively low long term fixed funding, which may be achievable in 2009/10, that 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.

6.3 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.

Sensitivity of the forecast - The main sensitivities of the forecast are likely to be the two scenarios below. In conjunction with the treasury advisers, we 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 are 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 growth rates remaining low or weakening, then long term borrowings will be postponed.

6.4 We plan to take £1m of additional longer-term borrowing on the West Midlands account in March 2009. As a result, we do not anticipate that further long-term borrowing will be needed during 2009/10.

7.0 DEBT RESCHEDULING AND PREMATURE REPAYMENT OPPORTUNITIES

7.1 We may consider rescheduling or premature repayment with the following aims:

- the generation of cash savings at minimum risk;
- in order to help fulfil the strategy outlined in 6 above;
- in order to enhance the balance of the long-term portfolio *(by amending the maturity profile and/or the balance of volatility).*

7.2 Any rescheduling or premature repayment will be reported to an appropriate committee at the meeting following its implementation.