Dudley
Metropolitan Borough Council

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.

Meeting of the Council – 27th February 2006

Report of the Audit Committee

Treasury Management

Purpose of Report

1. To seek approval of the Treasury Strategy Statement 2006/7.

Background

2. The Council undertakes treasury management activity on its own behalf and as administering authority for the West Midlands Debt Administration Fund *(WMDAF)*. The Council is responsible for administering capital funding of approximately £245m on its own account and another £232m on behalf of the WMDAF. The treasury function is governed by the Council's Treasury Policy Statement and Treasury Management Practices.

3. The Treasury Strategy Statement covers the latest capital funding requirements, a view of interest rate movements and a strategy for borrowing and investment in the light of that view. As such, it needs to be reviewed annually. The Treasury Strategy Statement for 2006/7 is attached as **Appendix 1**.

4. Expectations for interest rates over the next twelve months, which will be subject to continuous review with the Council's treasury advisors, are as follows:

   - **Short-term rates.** The Bank of England Base Rate (currently 4.50%) is expected to fall to 4.00% by the end of 2006. Subsequently, it is expected to rise, reaching 4.75% by the end of 2007.

- **Long-term rates.** The 25-year PWLB rate (currently 3.95%) is expected to rise steadily over the next two years, reaching 4.75% by the end of 2007.
- **Very long-term rates**. The 50-year PWLB rate (currently 3.75%) is expected to rise steadily over the next two years, reaching 4.50% by the end of 2007.

5. 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 the Council to set a number of prudential indicators. The full range of prudential indicators were considered by the Cabinet on 8th February 2006. The proposed indicators that relate to treasury management are set out in the Treasury Strategy Statement.

6. 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.

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

8. The recommendations of the meeting of the Audit Committee, held on 2nd February 2006, are set out in paragraphs 12 and 13 below.

Finance

9. Forecasts of performance against budget for treasury management activities are highly sensitive to movements in cash flow and interest rates. At this stage in the year a surplus of £1m on the Council's budget for 2005/6 is being forecast. This forecast is based on prudent assumptions and the final outturn may improve beyond this position.

Law

10. 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.

Equality Impact

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

Recommendations

12. That the Treasury Strategy 2006/7, attached as Appendix 1 to this report be approved.

13. That the Director of Finance be authorised to effect such borrowings, repayments and investments as are appropriate and consistent with the approved Treasury Strategy and relevant guidance.

…………………………………………..
Chairman of the Audit Committee

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 2006/7

1.0 INTRODUCTION

1.1 This Treasury Strategy Statement details the expected activities of the treasury function in the financial year 2006/7. 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 2006 is as follows:

	£m
Long-term debt:	
- PWLB fixed rate	174.2
- Market fixed rate	6.8
- Market LOBO[1]	10.0
Short-term debt	0.2
Total debt	191.2

2.2 The average rate of interest on the above debt is expected to be 6.2%.

2.3 The average level of investments held by the Council during 2004/5 was around £70million. By the last quarter of 2005 this had fallen, as expected in

[1] 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.

our plans, to around £40million. On 9th January 2006, in anticipation of need for borrowing in the course of the next year, we borrowed £10million from the PWLB at 3.90%. On 19th January we borrowed a further £10million at 3.70%. We are monitoring the position constantly to determine whether further borrowing is required.

2.4.1 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 2006 is as follows:

	£m
Long-term debt:	
- PWLB fixed rate	216.9
- Market fixed rate	6.8
- Market LOBO[2]	10.0
Short-term debt	-
Total debt	233.7

2.5 The average rate of interest charged to the West Midlands fund is expected to be 6.9%.

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.

[2] 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.

	2004/05	2005/06	2006/07 Revised	2007/08 Revised	2008/09
	£m	£m	£m	£m	£m
Authorised limit for external debt:					
Borrowing	n/a	529	535	538	538
Other long term liabilities	n/a	5	7	8	8
Total	**n/a**	**534**	**542**	**546**	**546**
Operational boundary:					
Borrowing	n/a	480	469	459	448
other long term liabilities	n/a	5	7	8	8
Total	**n/a**	**485**	**476**	**467**	**456**
Actual External Debt:					
Borrowing	415.0	n/a	n/a	n/a	n/a
Other long term liabilities	0.6	n/a	n/a	n/a	n/a
Total	**415.6**	**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.

	2005/06 %	2006/07 % Revised	2007/08 % Revised	2008/09 %
Upper limit for fixed interest rate exposure	100	100	100	100
Upper limit for variable rate exposure	45	30	20	15

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. A number of factors, including the following, have been taken into account:

- UK GDP growth to weaken from 3.2% in 2004 to about 1.7% in 2005 before rising to about 2.0% in 2006.
- Slowdown in household spending and rise in unemployment during 2005.
- House price inflation fallen to very low levels and may now stabilise.
- Rise in inflation concerns: high oil prices have pushed inflation up over target - but this is a one-off effect which will fall out even if oil prices remain at current levels.
- Increasing concerns that the public sector deficit will exceed targets significantly and lead to increases in taxation.

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 of England Base Rate (currently 4.50%) is expected to fall to 4.00% by the end of 2006. Subsequently, it is expected to rise, reaching 4.75% by the end of 2007.

- **Long-term rates.** The 25-year PWLB rate (currently 3.95%) is expected to rise steadily over the next two years, reaching 4.75% by the end of 2007.
- **Very long-term rates**. The 50-year PWLB rate (currently 3.75%) is expected to rise steadily over the next two years, reaching 4.50% by the end of 2007.

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.

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 Butler Asset Management.
- 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 deposits up to 364 days with UK building societies that have group assets of £1,000million or more (where these are not "specified investments" as defined above).	50%
Sterling-denominated euro-sterling bonds issued by supra-national institutions with a long-term credit rating of AAA.	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 (Schedule 7 to our Treasury Management Practices). 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 should not exceed 10% of our total pool of investments or £5million (whichever is greater). Investments with a group of banks should not exceed 15% 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 2006/7, 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 2006/7 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 On the West Midlands account it will not be necessary to undertake additional long-term borrowing during 2006/7.

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.