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 – 14th February 2008

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 2007/8 up to the end of December;
   - to seek approval of the Treasury Strategy Statement 2008/9.

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 £300m on our own account and another £225m on behalf of the WMDAF. The treasury function is governed by the Council's Treasury Policy Statement and Treasury Management Practices.

Treasury activity 2007/8 - Dudley fund

3. As anticipated in our Treasury Strategy Statement 2007/8, our invested balances have been falling steadily during the year, falling to around £9m after the payment of salaries at the end of November 2007. On 19th December 2007 we replenished these balances by borrowing £50m from the Public Works Loan Board (PWLB) to mature on dates between 2053 and 2057 at rates ranging from 4.61% to 4.63%. These funds were invested initially for periods ranging from 1 month to 6 months at rates ranging between 6.06% and 6.51%. We anticipate that these funds will be required to meet cash flow in the remainder of 2007/8 and in 2008/9.

4. The performance of our investments is largely dependent on movements in short-term *(up to one year)* rates. The behaviour of these rates during 2007/8 has been highly volatile, largely due to the knock-on effects of the sub-prime mortgage crisis in the United States. Our latest forecast for the average return on our investments for the year 2007/8 is 5.83%. The average 3-month LIBID[1] for the year to December has been 6.03%. The 3-month LIBID figure has risen sharply in the course of the year, reflecting the reluctance of banks to lend to one another during the sub-prime mortgage crisis. For reasons of cash flow and having taken a prudent approach particularly during the early stages of the crisis, Dudley has tended to invest for shorter periods than three months and, consequently, at slightly lower rates.

Treasury activity 2007/8 - WMDAF

5. 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. 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 2007/8 is 6.8%.

Treasury Strategy Statement 2008/9

6. 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 2008/9 is attached as **Appendix 1**.

7. Our expectations for interest rates over the next twelve months, which will be subject to continuous review with our treasury advisors, are as follows:

   - **Short-term rates.** The Bank of England Base Rate is expected to fall to 5% by the middle of 2008 and remain at that level into 2009.
   - **Long-term rates.** The 25-year PWLB rate is expected to fall slightly and remain around 4.55% into 2009.
   - **Very long-term rates**. The 50-year PWLB rate is expected to fall slightly and remain around 4.45% into 2009.

8. 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 will be considered by the Cabinet on 13th February 2008. The proposed indicators that relate to treasury management are set out in the Treasury Strategy Statement.

[1] 3-month LIBID is a measure of the average return from a 3-month investment on the London money market.

9. 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.

10. 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

11. 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 2007/8. This forecast is based on prudent assumptions and the final outturn may improve beyond this position.

Law

12. 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

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

Recommendation

14. That the Committee:

- note the treasury activities in 2007/8 outlined in this report;
- approve the Treasury Strategy 2008/9 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 2008/9

1.0 INTRODUCTION

1.1 This Treasury Strategy Statement details the expected activities of the treasury function in the financial year 2008/9. 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 2008 is as follows:

	£m
Long-term debt:	
- PWLB fixed rate	193.4
- Market fixed rate	6.8
- Market LOBO[2]	10.0
Short-term debt	0.2
Total debt	210.4

2.2 The average rate of interest on the above debt is expected to be 5.43%.

2.3 The average level of investments held by the Council during 2007/8 to the end of November was £29.4m and fell as low as £9m after the payment of salaries at

[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.

the end of November. On 19th December 2007, investment balances were replenished by borrowing £50m from the PWLB. Cash flow forecasts, consistent with the Council's overall capital and revenue budget strategy, suggest that these funds will be used up in the course of 2008/9. 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 2008 is as follows:

	£m
Long-term debt:	
- PWLB fixed rate	207.8
- Market fixed rate	6.8
- Market LOBO[3]	10.0
Short-term debt	1.4
Total debt	226.0

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.

[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.

	2006/07	2007/08	2008/09 Revised	2009/10 Revised	2010/11
	£m	£m	£m	£m	£m
Authorised limit for external debt:					
Borrowing	n/a	538	590	592	591
Other long term liabilities	n/a	5	6	7	7
Total	**n/a**	**543**	**596**	**599**	**598**
Operational boundary:					
Borrowing	n/a	473	518	518	510
other long term liabilities	n/a	5	6	7	7
Total	**n/a**	**478**	**524**	**525**	**517**
Actual External Debt:					
Borrowing	407.3	n/a	n/a	n/a	n/a
Other long term liabilities	1.9	n/a	n/a	n/a	n/a
Total	**409.3**	**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.

	2007/08 %	2008/09 % Revised	2009/10 % Revised	2010/11 %
Upper limit for fixed interest rate exposure	100	100	100	100
Upper limit for variable rate exposure	30	15	15	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:

International

- The US, UK and EU economies have all been on the upswing of the economic cycle during 2005 and 2006 and so interest rates were successively raised in order to cool their economies and to counter the build up of inflationary pressures.
- The US is ahead of both the UK and EU in the business cycle and started on the downswing of the economic cycle during 2007. The US Federal Reserve rate peaked at 5.25% and was subsequently cut several times, falling to 4.25% by December. This was a response to the rapidly deteriorating prospects for the economy in the face of the downturn in the housing market, the sub prime mortgage[4] crisis and the ensuing liquidity crisis which started in August 2007 and has subsequently resulted in banks making some major write offs of losses on debt instruments containing sub

[4] "Sub prime mortgages" is a term for loans given to customers with poor credit records. A number of banks have suffered losses directly or indirectly as a result of customers defaulting on these loans.

prime mortgages. Banks have also tightened their lending criteria which has hit hard those consumers with poor credit standing.

- The US Federal Reserve made further emergency rate cuts during January. The rate now stands at 3.50%. The US could well be heading into stagflation in 2008 – a combination of inflation and a static economy (but the economy could even tip into recession if the housing downturn becomes severe enough).
- The major feature of the US economy is a steepening downturn in the housing market which is being undermined by an excess stock of unsold houses stoked by defaulting sub prime borrowers pushed into forced sales. Falling house prices will also undermine household wealth and so lead to an increase in savings (which fell while house prices were rising healthily) and so conversely will lead to a fall in consumer expenditure. Petrol prices have trebled since 2003 and, with similar increases in the price of home heating oil, this will also depress consumer spending with knock on effects on house building, employment, etc.
- The downturn in economic growth in the US in 2008 will depress world growth, (especially in the western economies), which will also suffer directly under the impact of high oil prices. However strong growth in China and India will partially counteract some of this negative pressure.
- EU growth has been strong during 2006 and 2007 but will be caught by the general downturn in world growth in 2008.

UK

- GDP growth has been strong during 2007 and hit 3.3% year on year in the third quarter. Growth is expected to cool from 3.0% in 2007 as a whole to 2.0% in 2008.
- House prices started on the downswing in the third quarter of 2007 and this is expected to continue into 2008.
- The combination of increases in Bank Rate and hence mortgage rates, short term mortgage fixed rates expiring and being renewed at higher rates, food prices rising at their fastest rate since 1993 and increases in petrol prices, have all put consumer spending power under major pressure.
- Banks have also tightened their lending criteria since the sub prime crisis started and that will also dampen consumer expenditure via credit cards and on buying houses through obtaining mortgages.
- Government expenditure will be held under a tight reign for the next few years, undermining one of the main props of strong growth during this decade.
- The Bank of England’s Monetary Policy Committee is very concerned at the build up of inflationary pressures especially the rise in the oil price and the consequent likely knock on effects on general prices. The prices of UK manufactured goods have risen at the fastest rate in 16 years. Food prices have also risen at their fastest rate for fourteen years driven by strong demand from China and India. Consequently, the MPC is going to be much more cautious about cutting rates compared to the US Federal Reserve in the face of these very visible inflationary pressures. In addition, UK growth was still exceptionally strong in the third quarter of 2007, as has also been the growth in the money supply. However, if those pressures subside, then

there is further downward risk to the Sector forecast which currently expects the Bank Rate to fall in the first half of 2008 and stabilise at 5.0% for the next two years.

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 is expected to fall to 5% by the middle of 2008 and remain at that level into 2009.
- **Long-term rates.** The 25-year PWLB rate is expected to fall slightly and remain around 4.55% into 2009.
- **Very long-term rates**. The 50-year PWLB rate is expected to fall slightly and remain around 4.45% into 2009.

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. 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 2008/9, 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 2008/9 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 2008/9.

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.