

EAST AYRSHIRE COUNCIL

POLICY AND RESOURCES COMMITTEE – 27 MARCH 2007

TREASURY MANAGEMENT ANNUAL STRATEGY REPORT FOR 2007/2008

Report by Executive Head of Finance

1. PURPOSE OF REPORT

- 1.1** To seek the approval of the Committee of the proposed Treasury Management Strategy for the financial year 2007/08 and the prudential indicators in relation to treasury activity which are required to be set and approved by the Council in advance of the financial year.

2. BACKGROUND INFORMATION

- 2.1** The Local Government in Scotland Act 2003 (via regulation) requires the Council to adopt the CIPFA Prudential Code. The code operates by the provision of prudential indicators and requires the production of an annual treasury management strategy.
- 2.2** A report to this committee on 7 February 2007 sought Members' approval of the prudential indicators relating to capital expenditure plans, borrowing levels and affordability. These indicators considered the affordability and impact of capital expenditure decisions. There are further prudential indicators which cover the effective funding of these decisions through treasury activity which require approval and are included in this report.
- 2.3** Treasury Management activities are strictly regulated by statutory requirements and by the CIPFA Code of Practice for Treasury Management in the Public Services and the first prudential indicator in respect of Treasury Management is that the local authority has adopted this code. This council adopted the code on 2 May 2002, and as a result adopted a Treasury Management Policy and Practices Statement which requires that the Executive Head of Finance reports on annual treasury strategy to this Committee outlining the forecast activity for the coming year. A further report is produced after the year end to report on actual activity for the year.
- 2.4** A key requirement of the strategy report is to explain the risks and the management of these risks that are associated with the treasury management service. This strategy report covers: -
- The current treasury position
 - The expected movement in interest rates
 - The Council's borrowing and investment strategies
 - Treasury performance indicators and limits on activity

3. THE CURRENT TREASURY POSITION

3.1 Capital Expenditure

The councils approved capital investment plans are summarised below;

| | 2006/07 Budget £M | 2007/08 Estimated £M | 2008/09 Estimated £M | 2009/10 Estimated £M |
|--|-------------------------|----------------------------|----------------------------|----------------------------|
| General Services - 14 November 2006 | 30.176 | 40.136 | 16.779 | 12.305 |
| Addition 21 December 2006 | | 0.954 | 0.720 | |
| Addition 7 February 2007 | | 1.727 | | |
| Total General Services | 30.176 | 42.817 | 17.499 | 12.305 |
| Housing Revenue Account (HRA) | 13.660 | 15.027 | 15.027 | 18.180 |
| Total Gross Capital Expenditure | 43.836 | 57.844 | 32.526 | 30.485 |

3.2 Capital Financing Requirement

This indicator shows the resultant cumulative amount that the council will need to borrow to fund the capital programme at the end of each year and was approved by this committee on 7 February 2007.

| | 2006/07 Projected £M | 2007/08 Estimated £M | 2008/09 Estimated £M | 2009/10 Estimated £M |
|------------------------|-------------------------|----------------------------|----------------------------|----------------------------|
| CFR - General Services | 138.293 | 165.818 | 173.442 | 177.166 |
| CFR - HRA | 55.689 | 57.795 | 59.521 | 64.024 |
| Total CFR | 193.982 | 223.613 | 232.963 | 241.190 |

3.3 Authorised Limit for External Debt

This indicator sets a limit on the level of borrowing gross of investments for each financial year and was set by this committee on 7 February 2007. It includes a degree of headroom to cope with, for example unusual cash movements as well as allowing amounts required for the approved capital plans for future years to be borrowed where considered prudent.

| | 2006/07 Revised £M | 2007/08 Estimated £M | 2008/09 Estimated £M | 2009/10 Estimated £M |
|---|-----------------------|----------------------------|----------------------------|----------------------------|
| Authorised limit for external debt | 257.211 | 269.141 | 270.310 | 271.339 |

3.4 Operational Boundary for External Debt

This indicator represents the most likely maximum level of external debt. It is a management tool used for in-year monitoring purposes.

| | 2006/07 Revised £M | 2007/08 Estimated £M | 2008/09 Estimated £M | 2009/10 Estimated £M |
|--|-----------------------|----------------------------|----------------------------|----------------------------|
| Operational boundary for external debt | 252.361 | 263.551 | 264.486 | 265.309 |

3.5 Current Position

The following table shows the current Debt held by the council and the anticipated future levels of investments held. These levels are well below the Capital Financing Requirement and authorised and operational boundaries above and new borrowing is required over the forthcoming year.

| | Balance 31/03/07 £M | Average Interest Rate % | Balance 31/03/08 £M | Balance 31/03/09 £M |
|--------------------|---------------------------|----------------------------------|---------------------------|---------------------------|
| PWLB | 123.342 | 6.53% | 123.319 | 123.295 |
| Market Loans | 67.100 | 4.35% | 66.600 | 66.600 |
| Other | 0.913 | 5.61% | 0.858 | 0.803 |
| Total Debt | 191.355 | 5.76% | 190.778 | 190.698 |
| Investments | (43.000) | 5.35% | (45.000) | (45.000) |

4. EXPECTED MOVEMENT IN INTEREST RATES

- 4.1** The Council's treasury management advisors – Butlers provide regular economic forecasts the most recent of which is summarised in the following paragraphs.
- 4.2** Although there was common consensus towards the end of 2006 that future movements in interest rates would be upward, the timing of the first increase surprised most observers. A ¼% increase to 5.00% in November was quickly followed with a further ¼% rise in January 2007.
- 4.3** Recent published data relating to inflation has been more optimistic than expected, thus reducing the expectation of several further rate rises. It is also recognised that inflation is expected to reduce in the second half of 2007 as a result of significant fuel cost increases in 2006 falling from the index used to calculate rates. However, this reduction is regarded as more of technical adjustment rather than an indication that future prices will not increase. Consequently Butlers, in agreement with many market observers, are of the view that there is still room for another ¼% increase before rates peak.

- 4.4** The Monetary Policy Committee (MPC) will continue to closely monitor inflation data as there are currently several areas of concern which would advise against a policy of interest rate relaxation. The strenuous growth performance of some of the major industrialised countries has created fear of increased pressure on fuel and raw material prices, and there is also concern over the amount of spare capacity left in the UK economy to accommodate future growth without impacting on the cost of labour. As a result of these factors and the continued strength of the UK property market there is a degree of nervousness and uncertainty in the market which reduces the certainty of interest rate forecasts.
- 4.5** There is also uncertainty in the world economy with particular regard to the U.S. and German economies. Both are experiencing unexpectedly strong performances which have helped to raise concern regarding future long term interest rates. Interest rates in the U.S. in recent years have continued to increase and the expectation that there would be downward movement has never materialised. Once the U.S economy enters it's expected weaker phase and lower rates the certainty of lower long term rates will increase
- 4.6** Butlers' forecast is shown below indicating one more increase in the Base Rate in 2007 before a period of stability followed by a reduction in early 2008.

Medium-Term Rate Forecasts – Annual Averages %

| | Base Rate | 5-year Gilt | 20-yr Gilt | 50-yr Gilt |
|---------|-----------|-------------|------------|------------|
| 2007/08 | 5.40% | 5.10% | 4.60% | 4.10% |
| 2008/09 | 5.00% | 4.80% | 4.50% | 4.00% |
| 2009/10 | 4.80% | 4.50% | 4.30% | 3.90% |

- 4.7** The forecast is based on continued growth in the UK economy and other major world economies coupled with no significant inflationary pressures. If, however, some of the issues noted above do not result in low inflation expectation then there will be significant pressure to increase rates.

5. BORROWING AND DEBT STRATEGY 2006/07- 2009/10

- 5.1** The uncertainty over future interest rates increases the risks associated with treasury activity and the Council will continue take a cautious approach to its treasury strategy.
- 5.2** The Council's estimated net borrowing requirement for 2006/07 and future years based on the capital financing requirement in 3.2 above is shown in the table below. The combined borrowing requirement total for 2006/07 and 2007/08 is £32.183M of which it is planned to borrow £18M when our treasury advisors, who are currently monitoring rates for this purpose, consider that optimum interest rates are available. Further consideration will be given to borrowing the balance of £14.183M plus the 2008/09 & 2009/10 requirements later in the year, based on prevailing interest rates and rate projections at that time together with the necessity to borrow based on progress in the capital programme.

| | 2006/07 Projected £M | 2007/08 Estimated £M | 2008/09 Estimated £M | 2009/10 Estimated £M |
|------------------------------------|----------------------------|----------------------------|----------------------------|----------------------------|
| Movement in CFR | 11.568 | 29.631 | 9.351 | 8.227 |
| Borrowing over CFR brought forward | 9.017 | | | |
| Borrowing Requirement | 2.551 | 29.631 | 9.351 | 8.227 |

5.3 With the likelihood of increasing interest rates any future debt restructuring is likely to take place later in 2007/08 or in future years, although the Executive Head of Finance and treasury consultants will monitor prevailing rates for any opportunities during the year. Accounting changes effective from 1 April 2007 make future debt restructuring less financially beneficial than previously and therefore less likely. It should be noted that draft statutory guidance which has been issued for consultation should result in these accounting changes having no retrospective effect on previous restructuring.

6. INVESTMENT STRATEGY 2007/08 - 2009/10

6.1 The main principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment will also be a consideration. Adopting this main principle, action will be taken to ensure:

- (a)** There is sufficient liquidity within the investment portfolio. For this purpose consideration will be taken of the maximum periods for which funds may be prudently committed taking into account the current statutory limit of 364 days on the investment periods.
- (b)** That a policy is maintained covering the categories of investment types selected to invest in, the criteria for choosing investment counterparties with adequate security, and the monitoring of their security.

6.2 The Executive Head of Finance maintains a counterparty list in compliance with the approved Treasury Policies and Practices. At present this is a named list based on stipulated credit ratings at the time of review. It is proposed that this list is replaced with qualifying criteria where counterparty limits are set according to credit ratings and we deal with any counterparties whose ratings qualify. The advantage to this is that counterparties are under constant review. Having taken advice from our Treasury advisors the proposed criteria and limits are: -

| | Fitch | Moody's | Standard & Poors | Money Limit | Time Limit |
|---------------------------|---|----------------------|------------------|--------------|------------|
| Upper Limit | F1 / AA - / C / 3 | P-1 / Aa3 / C | A-1 / AA- | £10m | 364 days |
| Middle Limit | F1 / A- / C / 3 | P-1 / A3 / C | A-1 / A- | £7.5m | 364 days |
| Lower limit | Building Societies with assets greater than £1b and unrated subsidiaries whose parents fit into the upper and middle limits above | | | £5m | 6 months |
| Other Institutions | Other UK Local Authorities and Public Bodies e.g. fire, police etc | | | £10m | 364 days |

Note

There are 4 possible ratings for counterparties as detailed above: Short Term / Long Term / Individual / Support. In the above table Moody's do not utilise a Support Rating whilst Standard & Poors only provide criteria on Short and Long Term borrowing.

The existing restriction of no more than 25% of the total investment portfolio being held with any single counterparty would be maintained.

- 6.3** Current arrangements allow the utilisation of excess funds by giving short term loans through brokers to counterparties. It is proposed that in addition to the above instant access call accounts should be used enabling us to directly deposit and withdraw sums as required. These accounts would be subject to the same criteria and limits above, with the money limit being a combined limit of short term loan and deposit balances held.
- 6.4** Expectations on shorter-term interest rates, on which investment decisions are based, show a likelihood of peaking at 5.5% in 2007. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts. It is likely that investment decisions will be made for longer periods with fixed investments rates to lock in good value and security of return if opportunities arise. The Executive Head of Finance, under delegated powers, will undertake the most appropriate form of investments depending on the prevailing interest rates at the time, taking into account the risks shown in the forecast above.

7. TREASURY MANAGEMENT PRUDENTIAL INDICATORS AND LIMITS ON ACTIVITY

- 7.1** The Council adopted the Code of Practice on Treasury Management on 2 May 2002, and as a result adopted a treasury management policy and practices statement. This adoption meets the requirements of the first of the treasury prudential indicators.
- 7.2** There are four further treasury prudential indicators. The purpose of these prudential indicators is to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs. The indicators are:
- (a)** Upper limits on variable rate exposure – This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments.
 - (b)** Upper limits on fixed rate exposure – Similar to the previous indicator this covers a maximum limit on fixed interest rates.
 - (c)** Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

- (d) Total principal funds invested for greater than 364 days – These limits are set to reduce the need for early sale of an investment, and are based on the availability of investments after each year-end. The use of investments greater than 364 days, although under review, is currently prohibited in Scotland, so this indicator is set as nil. Indicative rates are proposed that would be adopted if legislation is enabled in the forthcoming financial year.

The Council is asked to approve the following prudential indicators:

Interest rate Exposure: -

| | 2007/08 Upper Limit | 2008/09 Upper Limit | 2009/10 Upper Limit |
|-------------------------------|---------------------------|---------------------------|---------------------------|
| Debt – variable rate interest | 50% | 50% | 50% |
| Debt – fixed rate interest | 100% | 100% | 100% |

Maturity of Long Term External Debt: -

| Maturity Period | Upper Limit | Lower Limit |
|----------------------|----------------|----------------|
| Under 12 months | 10% | 0% |
| 12 months to 2 years | 10% | 0% |
| 2 years to 5 years | 10% | 0% |
| 5 years to 10 years | 25% | 0% |
| 10 years and above | 100% | 0% |

Indicative Upper Limits on Sums Invested for more than 364 Days: -

| Investment Period | Upper Limit |
|----------------------|----------------|
| Under 12 months | 100% |
| 12 months to 2 years | 40% |
| 2 years to 5 years | 10% |
| 5 years to 10 years | 5% |
| 10 years and above | 5% |

8. PERFORMANCE INDICATORS

- 8.1 The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. Examples of performance indicators often used for the treasury function are:

- (a) Investment Activity – Comparison of average interest rates achieved for investments compared to average 7 day rate available.
- (b) Comparison of average rate of interest and expenses incurred during the financial year – “Pool Rate”.

The results of these indicators will be reported in the Treasury Annual Report for 2006/07.

10 BANKING SERVICES CONTRACT

- 10.1 Following a tendering exercise the councils banking services contract from 1 April 2007 has recently been awarded to the Clydesdale Bank who are the Councils' existing bankers.

11 FINANCIAL IMPLICATIONS

- 11.1 The financial implications of the proposed Treasury Management Strategy have been included within the respective estimates for the General Fund and the Housing Revenue Account for 2007/08.

12 POLICY/LEGAL IMPLICATIONS

- 12.1 The Treasury Management Policies and Practices will be updated as appropriate to reflect the above.

13 RECOMMENDATIONS

It is recommended that the Committee recommends that the Council: -

- 13.1 authorise the Executive Head of Finance to replace the named counterparty list with counterparty criteria as outlined in paragraph 6.2.
- 13.2 authorise the Executive Head of Finance to operate instant access call accounts as outlined in paragraph 6.3
- 13.3 approve the Prudential Indicators set out in paragraph 7.2; and
- 13.4 otherwise, note the content of the report.

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Executive Head of Finance

LS
2 March 2007

LIST OF BACKGROUND PAPERS NIL

Any person who wishes any further information on this report should contact Lorna Service, Exchequer Manager, Tel 01563 576405