TREASURY MANAGEMENT STRATEGY 2010/11 TO 2012/13

1 SUMMARY

1.1 This report sets out the Treasury Management Strategy for 2010/11 to 2012/13, which sets out the framework within which the Council's cash flows will be managed. The actual cost of borrowing and interest on investments will depend on market conditions and timing will be an important factor in decisions to be taken on the debt portfolio. The Strategy comprises the Capital Financing and Borrowing Strategy (section 9), the Investments Strategy (section 11), and the Affordable Limit for borrowing set out in section 4.

1.2 The Corporate Director of Finance & Risk Management shall be authorised to make amendments to any of the limits set out in this report both for Specified and Non-Specified investments, which may from time to time be necessary, in order to cope with changing market conditions and to protect the Council's interests by reducing any risk of loss of the principal sums invested.

2 RELATED DECISIONS

2.1 Cabinet is considering this strategy alongside the revenue and capital budgets for 2010/11 at its meeting on 16th February 2010 which contains provisions for the cost of borrowing consistent with the Treasury Management Strategy. The report also recommends that the Council sets its prudential borrowing limit and affordability prudential indicators. This report assumes that those recommendations will be approved by Council.

3. BACKGROUND

3.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in the Public Services requires local authorities to prepare an annual treasury management strategy for approval by Council for the following financial year.

3.2 CIPFA has defined treasury management as:

"the management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

3.3 The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Treasury management risks are identified in the Council's approved Treasury Management Practices; the main risks to the Council's treasury activities are:

- Credit and counterparty risk (security of investments)
- Liquidity risk (inadequate cash resources)
- Market or interest rate risk (fluctuations in interest rate levels and thereby in the return on investments).
- Refinancing risks (Impact of debt maturing in future years).
- Legal & regulatory risk (i.e. non-compliance with statutory and regulatory requirements, risk of fraud).

3.4 The strategy also takes into account the outlook for interest rates, the Council's current treasury position and it's approved Prudential Indicators. The PIs relevant to the treasury management strategy are set out in section 4 of this Annex.

3.5 Uncertainty in financial markets since September 2008 has led public bodies across the country to operate treasury policies with extreme caution, with emphasis on management of credit risk rather than income maximisation. With interest rates at their current historically low level and the limited number of counterparties considered sufficiently safe for term deposits, the level of investment income has dropped sharply in the current financial year and may stay at lower levels in the short to medium-term.

3.6 No new borrowing has been undertaken during the current year and loans are not expected to need to increase from their current level until 2011, when a combination of liquidity demands and maturity of some existing loans will reduce cash balances below optimum levels. However, with long-term interest rates forecast to rise at some point in the next three years, decisions will be needed on when further borrowing should be taken on.

4. Treasury Management Prudential Indicators and Limits on Activity

4.1 The Prudential Indicators relevant to the Treasury Management Strategy are set out below:

4.2 Authorised Limit and Operational Boundary for External Debt:

4.3 The Council uses officers' analysis of cashflow requirements in the medium-term to assess likely borrowing needs, and reports the following indicators:

a) Authorised Limit - the Council has set the Authorised Limit for its total external debt (i.e. gross of investments, in line with the balance sheet presentation of borrowing and long term liabilities). This prudential indicator separately identifies borrowing from other long-term liabilities such as finance leases. It is consistent with the Council's existing commitments, its proposals for capital expenditure and financing and its approved treasury management policy statement and practices.

The Authorised Limit has been set on the estimate of the most likely, prudent but not worst case scenario, but with sufficient headroom over and above this to allow for unusual cash movements.

The Authorised Limit is the statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit).

b) **Operational Boundary** - this links directly to the Council's plans for capital expenditure, the estimates of the capital financing requirement and the estimate of cashflow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely, prudent but not worst case scenario but without the additional headroom included within the Authorised Limit.

4.4 The Corporate Director of Finance and Risk Management has delegated authority, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long-term liabilities. Decisions will be based on the outcome of financial option appraisals and best value considerations. Any movement between these separate limits will be reported to the next meeting of the Cabinet.

4.5 Limits on Activity

4.6 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 too restrictively they will impair the opportunities to reduce costs. The indicators are:

- **Upper limits on variable interest rate exposure** – This indicator identifies a maximum limit for variable interest rates based upon the debt position net of investments.
- **Upper limits on fixed interest rate exposure** – Similar to the previous indicator, this covers a maximum limit on fixed interest rates.
- **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 funds after each year-end.
- **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.

4.7 The Council is asked to approve the following prudential indicators:

Table 1: Treasury Management Prudential Indicators

The PIs relevant to the Treasury Management Strategy are set out below:

PI No.		2009/10 Approved £000	2010/11 Estimate £000	2011/12 Estimate £000	2012/13 Estimate £000
6	Authorised Limit for External Debt	415,000	420,000	440,000	440,000
7	Operational Boundary for External Debt	395,000	400,000	420,000	420,000
9	Upper Limit for Fixed Interest Rate Exposure	400,000	405,000	425,000	425,000
10	Upper Limit for Variable Rate Exposure	30,000	30,000	30,000	30,000
12	Upper Limit for total principal sums invested over 364 days	30,000	30,000	30,000	30,000

Maturity Structure of fixed interest rate borrowing

	2010/11		2011/12		2012/13	
	Lower	Upper	Lower	Upper	Lower	Upper
Under 12 months	0%	15%	0%	15%	0%	15%
12 months - 2 years	0%	15%	0%	15%	0%	15%
2 years - 5 years	0%	50%	0%	50%	0%	50%
5 years - 10 years	0%	50%	0%	50%	0%	50%
10 years and above	60%	100%	60%	100%	60%	100%

5. The Current Treasury Position

5.1 The estimated treasury position for 31/3/2010 and for the following financial years is:

Table 2: Detailed Treasury Position

	Estimate 31/3/2010 £000	Estimate 31/3/2011 £000	Estimate 31/3/2012 £000	Estimate 31/3/2013 £000
Net borrowing	314,704	320,204	340,204	340,204
CFR	341,585	352,260	346,276	341,735

5.2 The Council borrows money to finance the capital programme. Other sources of finance for capital schemes include cash grants and contributions from third parties (principally developers). Where these other funds are received in advance of expenditure, as they normally are, the Council carries loans from the Public Works Loan Board as liabilities and deposits with financial institutions as assets concurrently. While the Council needs to ensure that it has sufficient liquid funds to meet its outgoings, it is most economical to limit both borrowing and deposits, as the interest paid on the loans will normally be at a higher rate than that receivable on the deposits. In addition, there are credit risks attached to holding substantial deposit balances. A strategic view is needed on what net cost of carrying balances is acceptable while still meeting the Council's liquidity needs.

5.3 The present level of investments is too high to invest comfortably with the small number of counterparties that the Council currently uses. It is proposed that the level of investments should be used to fund the capital programme and allowed to fall to £50m, which would meet the expected programme funding requirement to mid-2011. Under the current resources framework, further PWLB borrowing would need to be undertaken at that time. Whether the programme is funded through use of balances as proposed or through further borrowing, net debt is expected to increase during the forecast period. The chart below shows the expected net borrowing profile for the coming years, although it should be noted that these are subject to the delivery of the major elements of the capital programme in line with the current forecast profile. Any re-profiling of these programmes would affect the levels of net borrowing in any one year.

6. Outlook for Interest Rates (as at January 2010)

6.1 The interest rate and general economic outlook provided by the Council's treasury advisor, Sector Treasury Services (Sector), is attached at Annex M2. Their views are summarised below. However, it is clear that different commentators have divergent views of short and medium-term planning prospects, with wildly dissimilar opinions on the effect of current monetary policy on inflation, whether economies will fall further into recession or experience sharp growth, and the appropriate timescale for a tighter fiscal

policy. Sector have taken a 'middle view', which doesn't give a firm opinion on which way the economy will go other than that borrowing rates will rise.

Background

Central bankers intervened in October 2008 as the effective breakdown of financial systems threatened to destabilise the global economy. Actions included government-sponsored recapitalisations; the provision of liquidity and guarantees for lending; nationalisation of some private sector financial institutions; the removal of compromised assets from banks' balance sheets through special finance mechanisms; and co-ordinated emergency interest rates cuts. The UK remained in recession for the six quarters to September 2009, with only limited growth forecast by many analysts for 2010.

Outlook

- **Interest rates:** Sector's view is that long term gilt yields and PWLB rates will rise markedly. This analysis is not universally shared – while Sector's view is that 25-year borrowing rates will have risen from the current 4.5% to 5.0% by June 2011, the research consultancy Capital Economics expects the rate to have fallen to 3.75%, with Base Rate continuing at the current 0.5% for some years.

- **Inflation:** The current CPI is distorted by short-term government stimuli, which may also have affected share prices and asset prices generally. One view is that there is surplus capacity in the economy, and that when the short-term measures cease there is a risk of deflation; another is that quantitative easing is a form of cheap money that will inevitably feed through into inflation.

- **Labour market:** Even forecasters of strong growth led by increases in manufacturing activity and exports are not expecting rapid falls in unemployment, particularly as both major political parties have identified a need for quick action to reduce the fiscal deficit. Current levels of unemployment will impose downward pressure on wage inflation.

- **Housing / Consumer Confidence:** House prices rose by 9% between April and December 2009, following a 23% fall over the previous 20 months. While some analysts forecast a continued increase in prices, a more pessimistic view is that price to average earnings ratio is still well above the long-term trend, particularly for periods when the economy is in recession. On that basis, further substantial falls are possible with direct effects on the rate of new build - though in Milton Keynes for 2009/10 activity is expected to beat forecast with completions of some 1,200 dwellings.

- **Growth:** Analyst forecasts for UK growth by 2011 range from 1.5% to a return to the long-term average of 2.5%. In December 2009, HM Treasury restated their forecast figure of 3.5%.

Forecasts from Sector, Union Bank of Switzerland and Capital Economics for the UK Base Rate (as at January 2010) are:

	Jan10	Mar10	Jun10	Sep10	Dec10	Mar11	Jun11	Sep11	Dec11
Sector	0.50%	0.50%	0.50%	0.75%	1.00%	1.50%	2.25%	2.75%	3.25%
UBS	0.50%	0.50%	0.50%	0.75%	1.00%	1.50%	2.00%	2.50%	3.00%
Capital	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%

Base rate has been set at the unprecedented rate of 0.5% since March 2009. The economic outlook continues to provide significant challenges for the Council's treasury strategy in 2010/11.

7. Capital Financing and Borrowing Strategy

7.1 The Council's underlying need to borrow for capital purposes is measured by reference to its Capital Financing Requirement (CFR). The CFR will determine the Council's requirement to make a Minimum Revenue Provision (MRP) for debt redemption from within its revenue budget. Physical borrowing may be greater or less than the CFR.

Table 3: Capital Financing Requirement 2009/10 to 2012/13

PI No. 3 Capital Financing Requirement	**31/3/2010 Estimate £000**	**31/3/2011 Estimate £000**	**31/3/2012 Estimate £000**	**31/3/2013 Estimate £000**
Non-HRA	261,615	271,541	264,808	259,518
HRA*	79,970	80,719	81,468	82,217
Total CFR	**341,585**	**352,260**	**346,276**	**341,735**

7.2 In accordance with the Prudential Code, the Council will ensure that net external borrowing does not, except in the short term, exceed the CFR in the preceding year plus the estimates of any additional CFR for the current and next two financial years.

7.3 Capital expenditure not financed from internal resources (i.e. capital receipts, capital grants and contributions, revenue or reserves) will produce an increase in the CFR (the underlying need to borrow) and may in turn produce an increased requirement to charge MRP in the Revenue Account.

7.4 The cumulative estimate of the long-term borrowing requirement is calculated as follows:

Table 4: Expected Borrowing Requirement

	31/3/2010 Estimate £'000	31/3/2011 Estimate £000	31/3/2012 Estimate £000	31/3/2013 Estimate £000
Capital Financing Requirement	341,585	352,260	346,276	341,735
Less: Existing Profile of Borrowing and Other Long Term Liabilities	314,704	320,204	340,204	340,204
Borrowing Requirement	26,881	32,054	6,072	1,531

7.5 The Council prefers to maintain maximum control over its borrowing activities as well as flexibility on its loans portfolio. Capital expenditure levels, market conditions and interest rate levels will be monitored during the year in order to minimise borrowing costs over the medium to longer term. A prudent and pragmatic approach to borrowing will be maintained to minimise borrowing costs without compromising the longer-term stability of the portfolio, consistent with the Council's prudential indicators.

7.6 In conjunction with advice from its treasury advisor, Sector, the Council will keep under review the options it has in borrowing from the PWLB, the market and other sources identified in the Treasury Management Practices schedules (Section 4) up to the available capacity within its CFR and Authorised Limit for external debt.

7.7 The Council currently has over £100m on deposit with UK financial institutions. It is the view of officers that this could be reduced to a figure of around £50m without compromising the Council's liquidity needs. This reduction can be effected by applying the funds to the capital programme over the next 15 months rather than repaying PWLB loans.

7.8 A decision to run down the level of cash balances held will depend on:

(a) Whether long-term borrowing rates are expected to increase before spring 2011;

(b) Whether the effects of such an increase are temporary or long-term – a temporary increase could be avoided by using short-term loans at the time when replacement funding is needed;

(c) Whether the credit risks of holding higher balances and the cost of borrowing before funds are required for capital projects outweigh the possible benefit of borrowing now rather than when refinancing is needed.

7.9 Officer's opinion is that there is currently no definitive evidence that long-term PWLB borrowing rates are going to rise in the near future, and that a decision on taking out new loans should be deferred until there are clear market signals.

The outlook for fixed-rate borrowing:

7.10 Sector's view is that gilt yields (on which PWLB rates are based) will rise by 2011. Capital Economics are forecasting a fall. Morgan Stanley have suggested that historical benchmarks have been superseded, and that policy rates may in future be about two percentage points below past figures. This implies that the 25-year rate will settle at about 4% rather than the 6% suggested by other commentators. There is clearly widespread uncertainty.

7.11 The Council will evaluate with Sector the relative merits of a strategic exposure to variable rate debt. Decisions to borrow at low, variable rates of interest will be taken after considering the absolute level of longer term interest rate equivalents and the extent of variable rate earnings on the Council's investment balances. Should longer term rates move below the cost of variable rate borrowing any strategic exposure to variable interest rates will be reviewed and, if appropriate, reduced.

7.12 Actual borrowing undertaken and the timing will depend on capital expenditure levels, interest rate forecasts and market conditions during the year, in order to minimise borrowing costs. The Council will be advised by Sector on the specific timing of borrowing. This may include borrowing in advance of future years' requirements provided that overall borrowing is maintained within the Council's projected CFR and its approved Authorised Limit.

8. Debt Rescheduling

8.1 The Council will continue to maintain a flexible policy for debt rescheduling. Market volatility may provide opportunities for rescheduling debt from time to time. The rationale for rescheduling would be one or more of the following:

- Savings in interest costs with minimal risk.
- Balancing the volatility profile (i.e. the ratio of fixed to variable rate debt) of the debt portfolio.
- Amending the profile of maturing debt to reduce any inherent refinancing risks.

8.2 The Council has examined the potential for undertaking early repayment of some external debt to the PWLB in order to reduce the difference between its gross and net debt positions. However, the introduction by the PWLB of significantly lower repayment rates than new borrowing rates in November 2007 has meant that large premiums would be incurred by such action and would also do so in the near term; such levels of premiums cannot be justified on value for money grounds. PWLB has consulted in January 2010 on the possibility of reducing these premiums, and the Council will review its position if and when changes to PWLB policy follow.

8.3 Any rescheduling activity will be undertaken within the Council's treasury management policy and strategy. The Council will agree in advance with

Sector the strategy and framework within which debt will be repaid/rescheduled if opportunities arise. Thereafter the Council's debt portfolio will be monitored against equivalent interest rates and available refinancing options on a regular basis. As opportunities arise, they will be identified by Sector and discussed with the Council's officers.

8.4 All rescheduling activity will comply with the accounting requirements of the local authority SORP and regulatory requirements of the Capital Finance and Accounting Regulations (SI 2007 No 573 as amended by SI 2008/414).

9. Investment Strategy

Background

9.1 The Council will have regard to the CLG's Guidance on Local Government Investments ("the Guidance") issued in March 2004, any revisions to that guidance, the Audit Commission's report on Icelandic investments and the 2009 revised CIPFA Treasury Management in Public Services Code of Practice and Cross-Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities are: -

(a) the security of capital and
(b) the liquidity of its investments.

The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Council is low in order to give priority to security of its investments.

Investment Strategy

9.2 The speculative procedure of borrowing purely in order to invest is unlawful, but the treasury strategy will result in surplus investments arising from treasury activity from time to time.

9.3 Investments are categorised as 'Specified' or 'Non-Specified' investments based on the criteria in the CLG Guidance.

9.4 All investments, with the exception of those to other local authorities, will be placed only with those building societies and authorised deposit takers under the Financial Services and Markets Act 2000 allocated a satisfactory colour rating by Sector, whose list is updated monthly. This list is based upon credit ratings issued by the three main rating agencies. Any changes to ratings during the month are notified to the authority immediately and officers will review the amendment of holdings as appropriate.

9.5 If the number of good quality credit rated counterparties continues to fall officers will consider using internal funds as an alternative to borrowing in the short-term in order to reduce exposure to interest rate and credit risk.

9.6 Specified Investments

The majority of the Council's investments in 2010/11 will fall into the category of specified investments.

9.7 Non-Specified Investments

Prior to the start of each financial year officers will review which categories of non-specified investments they consider could be prudently used in the coming year. In doing this they will take advice from Sector.

The officer recommendation for 2010/11 is that long term investments (those for periods exceeding 364 days) could prudently be used where funds are not required for short-term cashflow management - for example, uncommitted capital receipts which the Council has agreed to invest as part of its budget strategy.

9.8 The maximum amount which the Council currently holds at any time as long term investments is £30m. As the forecast average total investments in 2010/11 is £92m, the investment of up to £30m at any one time for a period exceeding 364 days if interest rates are favourable can be undertaken without having a adverse effect on cashflow. Advice will be taken from Sector Treasury Services before entering into any long-term investments.

9.9 The balance of investments is influenced by several factors, including the timing of the actual delivery of the capital programme, use of reserves and balances and timing of receipts of grant and other external income. The level of investments is monitored on an ongoing basis.

10. Annual Investment Strategy

10.1 The Corporate Director - Finance and Risk Management, under delegated powers, will undertake the most appropriate form of investments in keeping with the investment objectives, income and risk management requirements and Prudential Indicators.

Investments managed in-house (Criteria for Lending):

10.2 The Council's shorter term cashflow investments are made with reference to the outlook for the UK Bank Rate and money market rates. For these monies, the Council will only invest in:

- Major UK banks which meet Sector's investment guidelines
- The Debt Management Agency Deposit Facility (The rates of interest from the DMADF are below equivalent money market rates. However, the returns are an acceptable trade-off for the guarantee that the Council's capital is secure.)
- AAA-rated Money Market Funds with a Constant Net Asset Value (Constant NAV) investing predominantly in government securities
- AAA-rated Money Market Funds with a Constant Net Asset Value (Constant NAV) investing in instruments issued primarily by financial institutions;

- Deposits with other local authorities
- Business reserve accounts

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10.3 All investment activity will comply with the accounting requirements of the local authority SORP.

11. Balanced Budget Requirement

11.1 The Council complies with the provisions of s.32 of the Local Government Finance Act 1992 to set a balanced budget.

12. Annual MRP Statement

12.1 The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 (SI 2008/414) place a duty on local authorities to make a prudent provision for debt redemption. Guidance on Minimum Revenue Provision has been issued by the Secretary of State and local authorities are required to “have regard” to such Guidance under section 21(1A) of the Local Government Act 2003.

12.2 The four MRP options available are:

Option 1: Regulatory Method - MRP continues to be calculated using the methods set out in the current capital finance regulations.

Option 2: CFR Method - MRP is calculated as 4% of the Non-HRA Capital Financing Requirement

Option 3: Asset Life Method - MRP is made in equal annual instalments over the life of the asset.

Option 4: Depreciation Method - MRP is broadly calculated as being equal to the amount of depreciation required for the asset.

12.3 For calculation of MRP in 2010/11, Options 1 and 2 may be used only for supported expenditure. Methods of making prudent provision for self financed expenditure include Options 3 and 4 (which may also be used for supported expenditure if the Council chooses).

12.4 The MRP Statement is submitted to Council before the start of the 2010/11 financial year as part of the budget setting process. If it is ever proposed to vary the terms of the original MRP Statement during the year, a revised statement should be put to Council at that time.

12.5 The Council will apply Option 1 in respect of supported capital expenditure. Where the Council undertakes unsupported borrowing, it will apply Option 3 (Equal Instalment Method method).

13. Reporting on the Treasury Outturn

13.1 The Corporate Director of Finance and Risk Management will report to the Council on treasury management activity and performance as follows:

- Activity – once a year against the strategy approved for the year
- Performance – an outturn report on its treasury activity no later that 30th September after the financial year end
- Additional reports will be submitted as required by market conditions and/or increased levels of treasury activity

ANNEX M1

TREASURY MANAGEMENT POLICY STATEMENT

Milton Keynes Council defines the policies and objectives of its treasury management activities as follows:-

1. Milton Keynes Council defines its treasury management activities as: "The management of the authority's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks"

2. Milton Keynes Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.
3. Milton Keynes Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

* Source – Chartered Institute of Public Finance and Accountancy (CIPFA) definition

1. Approved Activities

In accordance with the Council's Constitution and Delegated Powers, the Corporate Director of Finance and Risk Management and officers authorised by the Corporate Director, may arrange all investments, borrowing, repayment of debt outstanding and leasing required and permitted by the Local Government Act 2003. Borrowing must be contained within the limit determined under the Authorised Limit of the Prudential Code and used solely for the purpose of the Council's statutory functions. Treasury management operations will comply with the CIPFA Code of Practice.

2. Treasury Management Policy Objectives

The treasury management activities of the Council will be conducted to achieve the following policy objectives: -

(a) To ensure that risk to the Council's financial position is minimised by the adoption of sound debt management and investment practices;

(b) To ensure that borrowing costs are minimised consistent with a debt maturity profile which has a spread of maturities over future years;

(c) The overall average rate of interest on short-term investments to be greater than the average seven-day LIBID rate (source: Bloomberg),

whilst having regard to the security of funds and the minimisation of risk;

(d) To continue the policy of using receipts from the sale of assets to repay debt and taking opportunities to make premature debt repayments and restructuring of debt where it is advantageous to the Council.

3. **Adoption of the CIPFA Code of Practice**

The Council has adopted the key recommendations of CIPFA Treasury Management in the Public Services: Code of Practice (the Code), as described in Section 4 of that Code.

Accordingly, this organisation will create and maintain, as the cornerstones for effective treasury management:

- A Treasury Management Policy Statement, stating policies and objectives of its treasury management activities.
- Suitable Treasury Management Practices (TMPs), setting out the manner in which the organisation will seek to achieve those policies and objectives, prescribing how the Council will manage and control those activities.

The contents of the Policy Statement and TMPs will follow the recommendations contained in Sections 6 and 7 of the Code, subject only to amendment where necessary to reflect the particular circumstances of the Council. Such amendments will not result in the Council materially deviating from the Code's key recommendations.

- Cabinet will receive reports on its treasury management policies practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, and an annual report after its close, in the form prescribed in the TMPs.
- The Council delegates responsibility for the implementation, monitoring of its treasury management policies and practices to Cabinet, and for the execution and administration of treasury management decisions to the Corporate Director of Finance and Risk Management, who will act in accordance with the policy statement, TMPs and CIPFA's Standard of Professional Practice on Treasury Management.

4. **Investment of Cash Balances**

Investment of all balances arising from day to day cash flows, capital receipts, minimum revenue provisions and other financial reserves and provisions will be in accordance with Government regulations or guidelines to produce a maximum return having regard to the security of funds and the minimisation of risk. The spread of risk will be controlled by reference to the approved criteria and financial limits. Investment liquidity will be structured with regard to cash flow projections maintained under the authority of the Corporate Director of Finance and Risk Management

5. **Investment Names/Financial Limits**

Investments are to be made only to those institutions, which meet the approved criteria for lending, and within the current maximum financial limits as approved, by Cabinet and Council. Where investments in any of these institutions were made at a time where a higher maximum limit applied, the new maximum limit will be applied as existing investments mature. Between reports to Cabinet, the Corporate Director of Finance and Risk Management is authorised to revise, and further restrict or relax, the investment names/limits to reflect changes in market information and ratings.

6. **Legal Issues**

Borrowing and investment will be arranged efficiently through a range of brokers practising in the money markets and, in addition, the Corporate Director of Finance and Risk Management is authorised to deal directly with counterparties where it is advantageous to do so. The requirements of the Bank of England Non-Investment Products Code (NIPS) (Dec 2001) will be met in all the above arrangements.

7. **Use of Bankers**

Approved agreements are currently in place with RBS for the conduct of banking business for the Council. The Corporate Director of Finance and Risk Management is authorised to negotiate appropriate changes to the mandates which may be needed to cover any exceptional market circumstances to protect the Council's finances.

8. **Review**

The Corporate Director of Finance and Risk Management will report to Cabinet on the treasury management performance as follows:

(a) In February/March, as part of the budget process, setting out the strategy for the following financial year.

(b) As soon as practical following the financial year end and no later than October, setting out the actual outturn for the previous year.

(c) In October/November each year reporting progress against the original strategy approved for the year.

(d) Additional reports will be submitted as required by market conditions and/or increased levels of treasury activity

The Corporate Director of Finance and Risk Management will make such arrangements as are necessary for monitoring daily activities in the treasury functions.

ANNEX M2

ECONOMIC OUTLOOK AT JANUARY 2010 – SECTOR TREASURY SERVICES

1. Introduction

- The credit crunch storm of August 2007 eventually fed through to the near collapse of the world banking system in September 2008. This then pushed most of the major economies of the world into a very sharp recession in 2009 accompanied by a dearth of lending from banks anxious to rebuild their weakened balance sheets. Many governments were forced to recapitalise and rescue their major banks and central banks precipitately cut their central bank rates to 0.10 – 1.00% in order to counter the recession.
- The long awaited start of growth eventually came in quarter 3 2009 in the US and the EU. However, there was disappointment that the UK failed to emerge from recession in quarter 3.
- Inflation has plunged in most major economies and is currently not seen as being a problem for at least the next two years due to the large output gaps and high unemployment putting a lid on wage growth. In many countries there have been widespread pay freezes in 2009 and these are likely to be persistent for some time.
- Deflation could become a threat in some economies if they were to go into a significant double dip recession.
- Asian countries, especially China, are buoying world demand through their own stimulus measures.
- There still needs to be a radical world rebalancing of excess savings rates by cash rich Asian and oil based economies and excess consumption rates in Western economies if the world financial system is not to avoid a potential rerun of this major financial crisis in years to come.
- Most major economies have resorted to a huge expansion of fiscal stimulus packages in order to encourage a fast exit from recession. This, together with expenditure on direct support provided to ailing banks, has led to a drastic expansion in government debt levels which will take many years to eliminate and to restore the previous health of national finances.

2 Two growth scenarios

- The current big issue is ‘how quickly will the major world economies recover?’ There is a sharp division of opinion from forecasters on this question as set out below. The knock on effects on forecasts for interest rates can also be seen.

2.1 Strong recovery – Forecast by UBS

- This is a normal cyclical recovery which will be strong in the major world economies. The US still has potential to add further fiscal stimulus in 2010 to ensure that strong recovery continues after the current round of stimulus measures end. Growth in the EU is likely to be strong in 2010 and not require such help.

In the UK:

- GDP growth will almost get back to the long term average of about 2.5% in 2011 but is likely to peak in the first half of the year as inventory rebuilding and stimulus measures fade and fiscal contraction kicks in later in the year.
- The economy will rebalance with strong growth in exports and import substitution helped by strong recovery in the EU and the rest of the world.
- Sterling has depreciated by 25% since the peak in 2007 and is likely to stay weak.
- Consumer spending – only a mediocre recovery is expected due to a steady increase in the savings ratio from +5.6% in 2009 to about 8% in 2011 as consumers pay down debt or build cash balances. Consumer incomes will be held down by wage freezes and increases in taxation.
- House price recovery is expected to persist helped by a low Bank Rate for a prolonged period; the peak to trough fall in house prices is now expected to be no more than 20%. House prices to rise by about 6% in 2010, and 3% in 2011; mortgage approvals will rise back to the level of 75 - 80,000 per month needed to ensure a continuation of a trend of rising house prices.
- CPI inflation to peak @ 2.5% in early 2010 after the rise in VAT in January but then to fall to a trough near 1.5% in early 2011 and to stay below 2% for the rest of 2011.
- The current MPC attitude is one of hang on as long as possible before increasing Bank Rate. The aim of this would be to try to ensure that growth gets going at a decent rate and that Bank Rate gets back to 4 – 5% before the next recession and that all assets purchased through QE have been sold off by then. The first Bank Rate increase is expected in Q3 2009.
- If there is a change of Government in 2010 with a more aggressive fiscal approach then this could delay the timing of Bank Rate starting to go up.
- The fiscal deficit is 6.4% of GDP, about £90bn, which is expected to fall at £11bn p.a. over eight years at currently planned rates. This is similar to the peak deficit of 7% in 1990s which was remedied to a surplus of 1.6% in the space of 6 years helped by strong, steady economic growth of 3% p.a. supported by loose monetary policy that compensated for the fiscal squeeze.
- Gilt yields, especially longer term ones, are currently artificially low due to the Bank of England's Quantitative Easing operations. £200bn of gilts, commercial bonds and paper are being purchased under this

scheme which has inflated prices and depressed yields. Once this campaign ends, yields will inevitably rise but will also rise due to the huge level of issuance of new gilts to finance the fiscal deficit. Long gilt yields are therefore forecast to reach 6% during 2011.

- Gilt yields could rise higher if there was a hung Parliament in 2010 or if the fiscal situation deteriorates further.
- The major risk to this scenario would be a lack of supply of bank credit. However, it is felt that the Bank of England is on alert to ensure that this does not happen and would continue various measures to assist the expansion of credit.

2.2 <u>Weak recovery – Forecast by Capital Economics</u>

- The current economic cycle is not a normal business cycle but a balance sheet driven cycle. Over borrowed banks, corporates and consumers are focused on shrinking their levels of borrowing to more viable and affordable levels and this balance sheet adjustment will take several years to be effected. Repayment of debt will therefore act as a major head wind to the required increase in demand in the economy. Consequently there will only be weak economic recovery over the next few years after the initial sharp inventory rebuilding rebound fades. GDP growth is forecast to reach only +1.5% in 2011.
- Fiscal contraction will further dampen economic recovery driven by a strong political agenda to accelerate cuts in expenditure and increases in taxation after the general election in 2010.
- The consumer savings ratio will rise so as to eliminate over borrowing and to insure against people losing their jobs during this downturn. This will depress consumer expenditure, the main driver of the UK economy.
- Growth will also be hampered by a reduced supply of credit from weakened banks compounded by weak demand for credit.
- The eventual reversal of Quantitative Easing will take cash out of the economy and reduce demand in the economy.
- Unemployment is likely to rise to near to 3m in 2010 and take years to subside due to weak growth. High unemployment will reduce tax income and increase expenditure on benefits and the costs of local authority services.
- Inflation will not be a threat for several years as the current 6% output gap will take until 2014 to be eliminated.
- However, deflation is a major danger for some years: the major falls in manufacturing prices over the last 12 -18 months have still to feed through to the economy and then to impact wage deflation.
- CPI inflation will blip up over 2% in early 2010 but will then be on a strong downward trend to about -1% in 2011.
- There is no need for the MPC to change Bank Rate from 0.5% in 2010 or 2011 and possibly for 5 years as they will need to counter the fiscal contraction which will dampen demand in the economy.
- Long PWLB rates will FALL from current levels to near 4% in 2010 due to weak economic recovery and minimal inflation so that the real rate of return (net of inflation) on long gilts is healthy at these low levels

2.3 **Our Treasury Management advisors' (Sector) view**

- Sector recognises that at the current time it is difficult to have confidence as to exactly how strong the UK economic recovery will prove to be. Both the above scenarios are founded on major assumptions and research which could or could not turn out to be correct.
- Sector has adopted a more moderate view between these two scenarios outlined above i.e. a moderate return to growth.
- We do, however, feel that the risks that long term gilt yields and PWLB rates will rise markedly are high.
- There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas: -
  - degree of speed and severity of fiscal contraction after the general election
  - timing and amounts of the reversal of Quantitative Easing,
  - speed of recovery of banks' profitability and balance sheet imbalances
  - changes in the consumer savings ratio
  - rebalancing of the UK economy towards exporting and substituting imports
- The overall balance of risks is weighted to the downside i.e. the pace of economic growth disappoints and Bank Rate increases are delayed and / or lower
- There is an identifiable risk of a double dip recession and deleveraging creating a downward spiral of falling demand, falling jobs and falling prices and wages leading to deflation but this is considered to be a small risk and an extreme view at the current time on the basis of current evidence