

APPENDIX N**TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY 2008/09**Introduction

1. The Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management, that has previously been adopted by the County Council, requires that a Treasury Management Strategy is approved in advance of each financial year. An Annual Investment Strategy is also required to be approved by the full Council.
2. Whilst the two strategies could be considered separately, the overlap is such that the production of a single strategy report is sensible. Given that the performance of the Treasury Management function – interest paid on debt will be over £19m in 2008/09 and investment income of £6.5m is included within the 2008/09 revenue budget – has a significant impact onto the Council's overall financial position, the joint strategy is considered as part of the financial planning process.

Background

3. The term treasury management is defined as:-

“The management of the organisation's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with these activities; and the pursuit of optimum performance consistent with these risks.”
4. The Council's Treasury Policy Statement, a copy of which is included at the end of this report, provides for an annual report on strategy (i.e. this report), as well as one on performance. The report on performance will be produced for the Cabinet and the Scrutiny Commission before the end of July 2008.
5. The Council receives advice on all aspects of treasury management from Sector Treasury Services.

Annual Investment Strategy 2008/09

6. There are a substantial number of investment options available to Local Authorities, many of which were introduced to coincide with the Prudential Code for Capital Financing that commenced in April 2004. The investments are classified as 'specified' or 'non-specified' with the distinguishing factor being that 'non-specified' investments do not satisfy one of the two key criteria of having a credit rating and a maturity date of less than one year.
7. The full list of investments for which approval is being sought is laid out in the following table, and does not include any investments that were not included in last year's approved list. The central tenet of our treasury management strategy – that security of the capital sum invested is of paramount importance – is not compromised by the use of non-specified investments.

Investment	Repayment within 12 months	Level of Security	Maximum Period	Maximum % of Portfolio (1)
Term deposits with credit-rated institutions with maturities up to 1 year	Yes	Varied acceptable credit ratings, but high security	1 year	100
Money Market Funds	Yes	At least as high as acceptable credit – rated banks	Dependent on cash flow requirements	75
Term Deposits with UK Local Authorities up to 1 year	Yes	LA's do not have credit ratings, but high security	1 year	50
* Term Deposits with credit-rated institutions where borrower has option of extending repayment date beyond 1 year (commonly referred to as 'callables')	No	Varied acceptable credit ratings, but high security	5 years ^ø	25+
* Term Deposits with credit – rated institutions with fixed maturity period of between 1 and 2 years.	No	Varied acceptable credit ratings, but high security	2 years ^ø	20+
* Term Deposits with credit –rated institutions with fixed maturity period of between 2 and 3 years.	No	Varied acceptable credit ratings, but high security	3 years ^ø	10+

(1) As the value of the investment portfolio is variable, limit applies at time of agreeing investment. Subsequent changes in the level of the portfolio will not be classed as a breach of any limits.

* Non-specified investments

† Total maximum of investments greater than 1 year will be limited to 40% of the portfolio.

ø For the sake of clarity, if a forward deal (one where the start of the investment is at some future date) is agreed, the maximum period commences on the first date of investment.

8. The only non-specified investments for which approval is sought are ones that are lent to high-quality financial institutions and where there is no possibility of capital loss. There are a number of other non-specified investments that are available and for which no approval is being sought. All of the investments for which no approval is sought involve the possibility of some capital loss, either in the short or long-term, and are therefore not felt to be appropriate for the County Council.
9. Non-specified investments have been used to the Authority's financial advantage in recent years and will continue to be considered if they are felt to offer attractive returns relative to the risks involved. There has been no change to any of the non-specified investment limits to the limits approved last year.
10. The template above gives the broad categories into which individual loans fall, and is the same as that which is currently in force. Although the maximum amount that can be loaned to Money Market Funds (pooled funds with a very diverse range of cash and near-cash investments, and with the best credit rating available) is unchanged at 75% of the whole portfolio, the Treasury Policy Statement that is at the end of this report includes a maximum investment in any of these funds that has been increased to £25m from the current £15m. Given that these funds have AAA ratings (better than, for example, Barclays or HSBC) this is not considered to increase the risks involved, and the increased amount simply brings them into line with the limit for the UK clearing banks with very high ratings. There are occasions when these funds offer a meaningful yield advantage – notably in the current falling interest rate environment.

Treasury Management Strategy for 2008/09

11. The suggested strategy for 2008/09 is, in common with previous years, based on the premise that the minimisation of long-term net interest costs is best achieved by retaining sufficient flexibility to react to changes in short, medium and long-term interest rates. It is likely that the strategy will remain unchanged in the future.
12. Investment markets have a tendency to over exaggerate the long-term impact of short-term economic data. The anomalies thrown up by this over-emphasis on short-term trends can create opportunities, and it would be counter-productive to set any strategy which made it difficult to act on these opportunities.
13. The strategy covers:
 - Current portfolio position
 - Prospects for interest rates
 - Borrowing strategy
 - Extent of debt rescheduling opportunities
 - Investment strategy

Current Portfolio Position

14. On 31st January 2007 the Council's debt portfolio stood at £360.8m, including £11.25m in respect of the financing of the new ESPO building (where all costs are charged directly to ESPO). Included in the portfolio is £93.5m of debt which was borrowed under arrangements known as a LOBO (Lender's Option, Borrower's Option). The inclusion of these LOBO's makes averages more difficult to calculate, as their maturity and rate can vary. These LOBO's are structured as follows:
- (i) A full term of loan is agreed (in Leicestershire's case between 45 and 70 years).
 - (ii) Two interest rates are agreed. The first covers an initial period and the second covers the remainder of the loan.
 - (iii) The first rate and period is fixed and cannot be changed by either party under any circumstances.
 - (iv) The second rate is the minimum that can be paid. After the initial period the lender has the option, usually on a six-monthly basis, to increase the rate of interest payable.
 - (v) If the lender exercises the option to vary the interest rate, the borrower can either repay the loan (without penalty) or accept a new rate.
 - (vi) If the borrower accepts a new rate, this new rate effectively becomes a new minimum level of interest rate for the remaining period. The lender retains a six-monthly option to vary this rate, in which case the borrower may repay.
15. Two of the LOBO's, (for £20m in total) have reached their secondary period and, as the lender did not vary the interest rate, the loans have 'stepped up' to their higher rates and can now be called every six months. There is a further £53.5m that will enter its secondary period in 2008/09, £10m in 2009/10 and £10m in the middle of the next decade.

The LOBO's that are currently within the portfolio do not carry particularly significant risks in the event that they 'default' to a new, higher interest rate at the end of the initial period. Any attempt to increase the rate will almost undoubtedly meet with a repayment. The current debt portfolio averages can be assessed as follows:

Current running interest rate	= 5.36%
Rate assuming all LOBO's were payable at full interest rate	= 5.52%
Average date to maturity assuming LOBO repayment after initial period	= 35 years
Average date to maturity assuming all LOBO's run for full term	= 46 years

16. The Council has a requirement to borrow a total of approximately £27m over the next three financial years to finance capital expenditure. If the rates available at any stage are thought to be attractive, it is entirely possible that this funding will be taken in advance - alternatively it may be more advantageous to meet the capital expenditure through using revenue balances in the short-term, with the long-term financing being raised when rates are more attractive. As the sums involved are not particularly large in comparison to the Council's overall financial position, securing a financing rate that is attractive in the long term is more crucial than the impact that the timing of the borrowing will have in any one year.
17. The Council's 'lender of first choice' has, for a number of years, been the Public Works Loan Board (PWLB). The PWLB lends to Local Authorities at rates that are linked to, and only slightly above, the redemption yield on Government Bonds with a similar maturity period. Until fairly recently the PWLB set a single rate in each loan period at which it would both lend money, and on which the discount/premium on any prematurely repaid loans was calculated. This latter point was particularly useful as it allowed authorities to take advantage of movements in interest rates via 'rescheduling' - the repayment of one loan and its replacement with another, often in a different loan period or after a period of time had elapsed.

In November 2007, and with no warning, the PWLB changed from single-pricing for loans/early repayments to setting different rates for each activity, with the difference peaking at 0.45% for a 50 year loan. The early repayment of debt to PWLB is now very costly and it is difficult to foresee circumstances in which it would be an attractive option. This inability to undertake early repayment of debt in a cost-effective manner makes borrowing from PWLB in the first place much less attractive, particularly when the 'market' offers cheaper sources of finance (notably LOBO's). Whilst LOBO's do have certain drawbacks - their potentially variable interest rate referred to in paragraph 14 being the obvious one - and they undoubtedly require the borrower to be 'on their toes' when call periods arrive, it is entirely plausible that LOBO's will be the main future source of financing of capital expenditure. It is for this reason that approval has been sought to increase the Prudential Limits on variable rate loans elsewhere within the Medium Term Financial Strategy.

18. Cash balances available for lending continue to surprise on the upside, and currently average around £170m. This figure includes cash lent for schools, ESPO and the Pension Fund (averaging c. £30min total).

Prospects for Interest Rates

19. When the Bank of England raised interest rates to 5.75% in July 2007, the consensus view of economic commentators was that further rate rises were in the pipeline. When the extent of the sub-prime lending crisis (poor quality borrowers were defaulting on their loans and the assets on which they were secured - houses - were falling in value) in the US became clear in mid-August 2007, there was swift turnaround in sentiment. The UK economy cannot be immune from a significant US slowdown, and the Bank of England's Monetary Policy Committee (MPC) cut rates to 5.50% in December 2007. With inflation remaining a problem - petrol and electricity prices have risen substantially in recent months, for example - the MPC has less

scope to reduce rates than they might like, and they are likely to have to compromise between reducing rates to protect economic growth and risking inflation (their prime target) being higher than they would like. In any event, it seems inevitable that they will reduce rates over the course of 2008.

20. The prospect for interest rates at which the Council can borrow is likely to be influenced by what happens in the economy. Rates currently available are relatively attractive (around 4.50% for a 50 year loan from the PWLB), and these rates may increase quite significantly if inflation looks like staying high for a prolonged period. Alternatively the economy may slow markedly and the competitive environment may squeeze inflation lower, and if equity markets perform poorly the 'flight to quality' may see demand for bonds push long-term interest rates lower. Given the many different factors that can influence long-term interest rates, it is almost impossible at this stage to predict what will happen to rates over the next year-or-so.

Borrowing Strategy

21. The borrowing strategy will take account of the current maturity profile of the portfolio, but the attractiveness of rates will be the major consideration. If LOBO deals continue to remain competitively priced they will be actively considered, and their attractiveness relative to PWLB loans has increased as a result of the recent changes referred to in paragraph 17.
22. All borrowing decisions will be taken in the best long term interests of the Council. Potential short-term savings that bring unduly high risks will not be considered.

Extent of Debt Rescheduling Opportunities

23. Debt rescheduling, a factor that has allowed the Council to improve the average rate of the debt portfolio consistently over the last 10 years, is unlikely to be attractive as a result of the 'spread' that the PWLB now use. In complete contrast to the position prior to this change within PWLB practices, LOBO's are now more likely to offer the most cost-effective rescheduling opportunities.

Investment Strategy

24. The policy will be to invest with the approved institutions set out in the Treasury Policy Statement, and in line with the instruments agreed as part of the Annual Investment Strategy. Attempts will be made to secure the best possible return for the period that is consistent with cash flow requirements, although short-term borrowing to cover temporary shortfalls may occasionally be necessary.

TREASURY POLICY STATEMENT

1. SCOPE

This policy statement encompasses the following activities which together comprise the Treasury Management function:-

- Short and Long-Term Borrowing.
- Short and Medium Term Lending (including any cash held on behalf of the Pension Fund but excluding management of Pension Fund Investments).
- Capital Financing other than borrowing, including leasing and other credit arrangements.
- Overall management of cash resources.

2. ROLES IN RELATION TO TREASURY MANAGEMENT

The Council will agree the overall Treasury Management Policy. It will also agree the Annual Treasury Management Strategy and Annual Investment Strategy, which will be incorporated into a single strategy document. The Director of Corporate Resources and his staff will implement the strategy and act in accordance with the policy except in exceptional circumstances which will be reported to the Cabinet.

3. APPROVED SOURCES AND METHODS OF BORROWING/ FINANCING

- Public Works Loan Board (PWLB)
- All Banking Institutions on the Bank of England's official list using loan instruments and other credit arrangements.
- All leasing companies.

4. APPROVED ORGANISATIONS FOR LENDING

<u>Institution</u>	<u>Maximum Loan/Period of Loan</u>
UK Clearing Banks	£15m/60 months up to £25m/60 months (subject to acceptable credit rating)
Subsidiaries of UK Clearing Banks with own credit rating	£5m/6 months (within limit of Clearing Bank group)
Foreign Banks	£5m/6 months up to £15m/60 months depending on credit rating (which in all cases must be at least as good as the UK Clearing Banks)

Building Societies (14 only, mainly largest)	£5m/3 months up to £10m/60 months depending on size of asset base/credit rating
Money Market Funds	£25m limit within any AAA-rated fund
UK Local Authorities	£10m/12 months

Institutions will be removed from the list where there are doubts about their security.

5. POLICY ON DELEGATION

The implementation of all Treasury Management activities is delegated (under the current Scheme of Delegation) to the Director of Corporate Resources. The policies set out in this statement will be observed other than in exceptional circumstances when changes in policy will be approved by the Director or the Head of Strategic Finance.

6. REPORTING ARRANGEMENTS

A review of the Treasury Management policy and the proposed strategy for the forthcoming year will be undertaken and reported to the Council.

There will be an annual report of Treasury Management activities of the previous financial year which will be produced for the Cabinet and the Resources Scrutiny Committee before the end of July.

7. POLICY ON EXTERNAL MANAGERS

The current policy will be not to employ external managers, other than to the extent that a Money Market Fund could be classified as an external manager.