REPORT TO: **FINANCE COMMITTEE – 8 MARCH 2004**

REPORT ON: **TREASURY MANAGEMENT STRATEGY 2004/2005**

REPORT BY: **DIRECTOR OF FINANCE**

REPORT NO: **96-2004**

1 PURPOSE OF REPORT

This report introduces the Dundee City Council Treasury Management Strategy for 2004/2005, the preparation of which is a requirement of the Council's Treasury Policy Statement and the CIPFA Code of Practice on Treasury Management.

2 RECOMMENDATION

The Committee are asked to:

1 note that in terms of the Treasury Policy Statement, the Director of Finance is obliged to present the annual Treasury Management Strategy at the start of each financial year.

2 approve the strategy proposed by the Director of Finance for 2004/2005 as set out in the attached document "Treasury Management Strategy 2004/2005".

3 FINANCIAL IMPLICATIONS

There are no direct financial implications arising from the recommendations in this report. However, decisions made within the Treasury Management function will affect the cost of the Council's long and short-term borrowing in 2004/2005 and future years. The 2004/05 Revenue Budget has been set including a provision of £19.865m for Capital Financing Costs and this is based on an average Loans Fund Interest rate of 6.05%.

4 LOCAL AGENDA 21 IMPLICATIONS

None.

5 EQUAL OPPORTUNITIES IMPLICATIONS

None.

6 BACKGROUND

The Council's Treasury Policy Statement approved on 11 March 2002 requires that the Finance Committee will receive and consider the Treasury Management Strategy in advance of each new financial year.

The Prudential Code for Capital Finance is applicable from 1 April 2004 onwards. This introduces new requirements for the manner in which capital spending plans are to be considered and approved and in conjunction with this the development of an integrated treasury management strategy.

This introduces some additional treasury management indicators which were included in Report No 53-2004 to the Committee on 12 January.

7 TREASURY MANAGEMENT STRATEGY 2004/2005

The Council's Treasury Management Strategy for 2004/2005 is set out in detail in the attached document. In summary, long-term borrowing rates are higher than short-term rates and this is expected to continue throughout 2004/2005. Short-term rates are expected to stay the same or fall slightly during 2004/2005. Interest savings will be maximised by utilising long-term borrowing facilities, where appropriate, to take advantage of low long-term interest rates and using short-term borrowing, where appropriate, to take advantage of any differential from long-term rates.

8 BACKGROUND PAPERS

No background papers, as defined by Section 50D of the Local Government (Scotland) Act 1973 (other than any containing confidential or exempt information) were relied on to any material extent in preparing the above Report.

DAVID K DORWARD
DEPUTE CHIEF EXECUTIVE (FINANCE) **17 FEBRUARY 2004**

DUNDEE CITY COUNCIL

TREASURY MANAGEMENT STRATEGY 2004/2005

Finance Department
Dundee

TREASURY MANAGEMENT STRATEGY 2004/2005

1 INTRODUCTION

This Treasury Management Strategy details the expected activities of the Treasury Management function in the financial year 2004/2005. Its production and submission to the Finance Committee is a requirement of the Council's approved Treasury Policy Statement. Its format and structure is in the format required by the approved Policy. The suggested strategy for 2004/2005 in respect of the following aspects of the treasury management function is based upon the officers views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisers. The strategy covers:

- The current treasury position;
- Treasury limits in force which will limit the treasury risk and activities of the Council;
- Prospects for interest rates;
- Capital borrowings required and the portfolio strategy;
- Temporary Lending strategy;
- Debt rescheduling.

2 PRUDENTIAL INDICATORS FOR 2004/05-2006/07

The indicators reported to Committee on 12 January 2004 are relevant to the integrated treasury management strategy. These are reproduced at Appendix 3.

3 CURRENT TREASURY PORTFOLIO POSITION

The Council's loan debt position at 31 January 2004 was as follows:

		£m	£m	%
Fixed Rate Funding	Public Works Loan Board	226.9		
	Market Loans	2.9	229.8	84.1
Variable Rate Funding	Public Works Loan Board	22.5		
	Market Loans	12.7		
	Temporary Loans	8.3	43.5	15.9
Total Loan Debt			273.3	100.0

4 TREASURY LIMITS FOR 2004/2005

In accordance with the Council's Prudential Indicators for Treasury Management, the Treasury limits set by Council as part of its Treasury Management policy are:-

• the amount of the overall borrowing limit which may be fixed rate maturing - under one year (10% of total debt)	Circa £27m
• the maximum proportion of interest on borrowing which is subject to variable rate interest. (30% of total debt)	Circa £82m
• the maximum proportion of interest on borrowing which is subject to fixed rate interest - (100% of total debt)	Circa £290m
• authorised limit for external borrowing	£315m

5 PROSPECTS FOR INTEREST RATES

The Council appointed Sector Treasury Services, as treasury advisers to the Council and part of their service is to assist the Council to formulate a view on interest rates. Appendix A draws together a number of current City forecasts for short term or variable and longer fixed interest rates for 2004/2005.

The effect on interest rates for the UK is expected to be as follows:

Shorter term interest rates – Base rate was increased to 3.75% in November from its previous 48-year low of 3.5%. The Chancellor has changed the inflation target for the Bank of England and the outlook for inflation is benign. It is therefore expected that the upside potential for base rates is limited and they are expected to be at 4.0% (the current position following 0.25% rise in January) for most of 2004 although rising to 4.25% by the end.

Longer term interest rates – PWLB rates were at low levels during the first half of 2003. As expectations of economic recovery increased equity values increased and gilt prices fell. This pushed up PWLB rates to 5%+. It is expected that they will stabilise at around 5.0% for most of 2004/05 which is still below normal long term levels.

6 CAPITAL BORROWINGS REQUIRED AND THE PORTFOLIO STRATEGY

Based upon the prospects for interest rates outlined above, there are a number of strategy options available. The anticipation is that short-term rates will continue to be cheaper than long fixed rate borrowing during 2004/05. Short term rates are expected to rise in line with base rates. Long term rates are not currently expected to move far but if there is a major fall in share prices, then long rates would be susceptible to a corresponding fall. These expectations provide a variety of options:

- that short term rates will be good value compared to long term rates, and are expected to remain so for the next two years, so that best value will be achieved by borrowing short term at variable rates, or for short fixed periods, in order to minimise borrowing costs in the short term or to make short term savings required in order to meet budgetary constraints.

- that the risks intrinsic in the shorter term variable rates are such, when compared to relatively low long term funding, which may be achievable in 2004/05, that the Council will maintain a stable, longer term portfolio by drawing longer term fixed rate funding at a marginally higher rate.

Against this background caution will be adopted with the 2004/05 treasury operations. The Depute Chief Executive (Finance) will monitor the interest rate market and adopt a pragmatic approach to any changing circumstances.

Sensitivity of the forecast - The main sensitivities of the forecast are likely to be the two scenarios below. The Council officers, in conjunction with the treasury advisers, will continually monitor both the prevailing interest rates and the market forecasts, adopting the following responses to a change of view:

- *a significant risk of sharp rise in long and short term rates*, perhaps arising from an increase in world economic activity. In this event the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are relatively cheap.

- *a significant risk of sharp fall in long and short term rates*, due to e.g. growth rates remaining low or weakening. In this event long term borrowings will be postponed, and any rescheduling from fixed rate funding into variable or short rate funding will be exercised.

7 TEMPORARY LENDING STRATEGY

It is not the Council's policy to be in a lending position although there are occasions when due to timing of cashflows the Council is lending funds for short periods of time.

Where the Council finds itself lending funds it will maximise its return taking into account the availability of interest rates and its own cashflow requirement.

Short term lending will be restricted to only those institutions identified in the Council's Approved Counterparties list. (Shown at Appendix B) provided they have maintained their credit rating. This list updates that contained in the Council's Treasury Policy Statement.

8 DEBT RESCHEDULING

The differential between short term and long term rates is sufficient to provide some potential for debt restructuring. Possible reasons for rescheduling would include:

- cash savings at minimal risk
- help fulfil portfolio strategy
- enhance balance of the long term profile with respect to maturity and volatility

APPENDIX A

OUTLOOK FOR INTEREST RATES

The data below shows a variety of forecasts published by a number of institutions. The first three are individual forecasts including those of UBS and Capital Economics (an independent forecasting consultancy), who both provide economic forecasting for Sector. The final two represent summarised figures drawn from the population of all major City banks and academic institutions. The current data shows the rates at the time of issue, not necessarily current rates. The forecast within the strategy statement has been drawn from these diverse sources and officers own views.

Individual Banks Forecasts

Sector Economic interest rate forecast (for quarter ends) - January 2004

(%)	Q1 2004	Q2 2004	Q3 2004	Q4 2004	Q1 2005
Base Rate	4.00%	4.00%	4.25%	4.25%	4.25%
10 Year PWLB	5.00%	5.00%	5.00%	5.00%	5.00%
25 Year PWLB	4.75%	4.75%	5.00%	5.00%	5.00%

Capital Economics interest rate forecast - January 2004

(%)	Q1 2004	Q2 2004	Q3 2004	Q4 2004	Q1 2005
Base Rate	4.00%	4.25%	4.25%	4.25%	4.25%
10 Year PWLB	5.35%	5.25%	5.15%	4.85%	4.75%
25 Year PWLB	5.05%	5.05%	5.05%	4.95%	4.85%

UBS interest rate forecast - January 2004

(%)	Q1 2004	Q2 2004	Q3 2004	Q4 2004	Q1 2005
Base Rate	4.00%	4.00%	4.25%	4.50%	4.50%
10 Year PWLB	5.15%	5.15%	5.25%	5.25%	5.40%
25 Year PWLB	5.25%	5.35%	5.45%	5.65%	5.65%

Summary Bank Forecasts

HM Treasury - summary of 35 independent forecasters views of base rate - as at January 2004 (2005-2007 are as at November 2003)

(%)	**2004** Year End	**2005** Average	**2006** Average	**2007** Average
Average	4.47%	4.78%	5.05%	4.93%
Highest	4.50%	5.72%	5.60%	5.60%
Lowest	4.00%	4.00%	3.81%	3.84%

APPENDIX B

APPROVED COUNTERPARTIES FOR LENDING TRANSACTIONS

Approved Lending Bodies	Short Term Credit Rating	Maximum Deposits £m
Banks		
Abbey National plc	F1+	10
HBOS (formerly Bank of Scotland and Halifax)	F1+	10
Barclays Bank plc	F1+	10
* Clydesdale Bank plc (National Australia Bank)	F1+	10
Lloyds TSB Bank plc	F1+	10
HSBC Bank plc	F1+	10
Royal Bank of Scotland plc (inc National Westminster)	F1+	10
Alliance and Leicester plc	F1+	10
Bradford & Bingley plc	F1	5
Anglo Irish Bank Corporation	F1	5
Building Societies		
Nationwide Building Society	F1+	10
Britannia Building Society	F1	5
Coventry Building Society	F1	5
Skipton Building Society	F1	5
Principality Building Society	F1	5
Yorkshire Building Society	F1	5
Other		
Scottish Local Authorities	N/A	5
English and Welsh Local Authorities	N/A	5

* This bank is a wholly owned subsidiary of the bank in brackets and the rating quoted refers to the parent bank.

NB Credit ratings indicate the capacity for timely repayments as follows:

F1+ strongest
F1 strong
F2 satisfactory
F3 adequate
B uncertain
C highly uncertain
D actual or imminent default

APPENDIX C

PRUDENTIAL INDICATORS - TREASURY MANAGEMENT

Adoption of CIPFA Code of Practice for Treasury Management	YES

Upper Limit for borrowing that is at variable rates less investments that are variable rate investments

	%
2004/05	30
2005/06	30
2006/07	30

Upper Limit for borrowing that is at fixed rates less investments that are fixed rate investments

2004/05	100
2005/06	100
2006/07	100

Limit for 2004/05 for amount of projected borrowing that is fixed rate maturing in each period as percentage of total projected borrowing that is fixed at the start of the period

Where the periods are:

	Lower %	Upper %
Under 12 months	0	10
12 months & within 24 months	0	15
24 months & within 5 years	0	25
5 years & within 10 years	0	25
10 years +	50	95

Upper limit for sums invested for periods longer than 364	N/A

Authorised Limit for external debt with limit for borrowing and other long term liabilities separately identified

	Borrowing £000	Other £000	Total £000
2004/05	315,000	5,000	320,000
2005/06	335,000	5,000	340,000
2006/07	352,000	5,000	357,000

Operational Boundary for external debt with limit for borrowing and other long term liabilities separately identified

	Borrowing £000	Other £000	Total £000
2004/05	290,000	1,000	291,000
2005/06	310,000	1,000	311,000
2006/07	327,000	1,000	328,000

Estimates of Capital Financing Requirements

	non HRA £000	HRA £000	Total £000
2004/05	190,000	125,000	315,000
2005/06	200,000	132,000	332,000
2006/07	207,000	137,000	344,000