HEREFORDSHIRE COUNCIL

APPENDIX 5

HEREFORDSHIRE COUNCIL

TREASURY MANAGEMENT STRATEGY 2004/05

1. INTRODUCTION

1.1 The Financial Policy Team is responsible, under the direction of the County Treasurer, for the day-to-day management of the Council's treasury management activities. The Treasury Management Strategy for 2004/05 details the expected activities for the team in the coming financial year and has been produced in accordance with the Council's approved Treasury Management Policy Statement.

1.2 The 2003 Prudential Code for Capital Finance in local authorities has introduced new requirements for the manner in which capital spending plans are to be considered and approved, and in conjunction with this, the development of this integrated Treasury Management Strategy.

1.3 The Treasury Management Strategy covers the:

- Current treasury portfolio position
- Treasury limits for 2004/05
- Prudential indicators for 2004/05 – 2006/07
- Prospects for the economy and interest rates
- Borrowing strategy
- Investment strategy
- Debt rescheduling opportunities

2. CURRENT TREASURY PORTFOLIO POSITION

2.1 The Council's treasury portfolio position as at 31 December 2003 is as follows:

DEBT POSITION	**Principal**	**Average Rate**
	(£)	**(%)**
Public Works Loan Board	53,259,920	5.68
Total Debt	**53,259,920**	

Estimated Borrowing Requirement for 2004/05 – supported borrowing approvals of approximately £15,800,000, plus the potential for an additional £5,000,000 unsupported borrowing under the Prudential Code, which includes £1,800,000 borrowing already approved by Members.

INVESTMENT POSITION	Principal (£)	Average Rate (%)
Internally managed funds	27,390,000	3.88
Externally managed funds	6,759,307	2.34
Total Investments	**34,149,307**	

Note:

Total investments will decline sharply in the last three months of the financial year as capital projects near completion.

3. TREASURY LIMITS FOR 2004/05

3.1 It is a statutory duty under Section 3 of the Local Government Act 2003, and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the "Affordable Borrowing Limit".

3.2 The Council must have regard to the Prudential Code when setting its Affordable Borrowing Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax levels is 'acceptable'.

3.3 Whilst termed an "Affordable Borrowing Limit", the capital plans to be considered for inclusion incorporate those planned to be financed by both external borrowing and other forms of liability, such as credit arrangements. The affordable borrowing limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.

4. TREASURY MANAGEMENT PRUDENTIAL INDICATORS FOR 2004/05 – 2006/07

4.1 The following prudential indicators are relevant for the purposes of setting an integrated Treasury Management Strategy.

	PRUDENTIAL INDICATOR	2003/04	2004/05	2005/06	2006/07
1	**Affordable Borrowing Limit**	**£ p**	**£ p**	**£ p**	**£ p**
	Increase in council tax (Band D, per annum)				
	Previously agreed Prudential Borrowing re the North Herefordshire Pool.	N/A	1.35	2.73	3.01
	Position if £5,000,000 Prudential Borrowing is taken for 2004/05.	N/A	3.75	7.06	7.34
	Position if £5,000,000 Prudential Borrowing is taken for 2004/05 and subsequent years.	N/A	3.75	10.52	17.28

	PRUDENTIAL INDICATOR	2003/04	2004/05	2005/06	2006/07
		£'000	**£'000**	**£'000**	**£'000**
2	**Capital Financing Requirement (as at 31/3)**				
	Total	**78,090**	**94,892**	**111,063**	**126,538**
3	**Authorised Limit for External Debt**	**£'000**	**£'000**	**£'000**	**£'000**
	Borrowing	105,000	119,000	142,000	163,000
	Other Long Term Liabilities	1,500	3,000	3,000	3,000
	Total	**106,500**	**122,000**	**145,000**	**166,000**
4	**Operational Boundary**	**£'000**	**£'000**	**£'000**	**£'000**
	Borrowing	63,000	73,500	94,500	115,500
	Other Long Term Liabilities	1,500	1,500	1,500	1,500
	Total	**64,500**	**75,000**	**96,000**	**117,000**
5	**Upper Limit for Fixed Interest Rate Exposure**	**£ or %**	**£ or %**	**£ or %**	**£ or %**
	Net principal re fixed rate borrowing / investments	100%	100%	100%	100%
6	**Upper Limit for Variable Interest Rate Exposure**	**£ or %**	**£ or %**	**£ or %**	**£ or %**
	Net principal re variable rate borrowing / investments	25%	50%	50%	50%
7	**Maturity Structure of new fixed rate borrowing during 2004/05**	**Upper Limit**	**Lower Limit**		
	Under 12 Months	30%	0%		
	12 months and within 24 months	60%	0%		
	24 months and within 5 years	90%	0%		
	5 years and within 10 years	100%	0%		
	10 years and above	100%	20%		
8	**Upper Limit for total principal sums invested for over 364 days**	**2003/04**	**2004/05**	**2005/06**	**2006/07**
		£'000	**£'000**	**£'000**	**£'000**
	(per maturity date)	7,000	10,000	10,000	10,000

5. PROSPECTS FOR THE ECONOMY & INTEREST RATES

5.1 The Council retains Sector Treasury Services Limited as its treasury advisers and part of its service is to assist in forming a view on economic trends and the effect on interest rates. This section of the strategy outlines the Council's view of the economy and interest rates based on the advice of its treasury advisers.

The Economy

5.2 **Shorter term rates -** Base rate was cut by 0.25% in July 2003, to a new 48-year low of 3.50% owing to hesitant recovery after the Iraq war and a climbing pound. With hindsight, this now appears to have been an over-cautious move as this cut was reversed in November 2003. However, the Chancellor announced a switch of inflation target for the Monetary Policy Committee (MPC) in the Pre Budget Report in December 2003 from plus or minus 1% around 2.5% on RPIX (Retail Prices Index excluding mortgages) to plus or minus 1% around 2% on CPI (consumer prices index). CPI has been running at 1.1–1.6% throughout 2003 and is forecast to average 1.4% in 2003, 1.7% in 2004 and 1.4% in 2005 i.e. below the likely target. In addition, wage inflation and producer price inflation are running at benign levels and oil prices are likely to come down from current high levels.

5.3 There is, therefore, likely to be little inflationary pressure to raise base rate. In addition, the potential for base rate to increase is limited by the heightened sensitivity of consumers to interest rate rises owing to the huge increase in personal borrowing in recent years and increase in base rate from 3.5% to 4.5% is an increase of 29% in likely borrowing rates. In view of the likely fragility of consumer demand in 2004 and in the UK, and owing to the likelihood of growth in the US falling back in 2004 to only a modest rate and weak growth expected in the Eurozone in 2004, it is expected that base rate will only rise to 4.25% by the end of 2004 after being at 4.0% for most of the year.

5.4 **Longer-term interest rates** – PWLB rates were at low levels during the first half of 2003 owing to investor fears over the Iraq war which depressed share values and gilt yields. Equity values have increased by about 25-30% from the low point to which they plummeted before the Iraq war, on expectations that the surge in economic recovery in the second half of 2003 will last well into 2004 and beyond and so boost corporate earnings.

5.5 Gilt prices have consequently fallen, causing increases in gilt yields and long-term PWLB rates which incurred a sharp unexpected increase in October 2003 on a surge in optimism on US economic recovery. This pushed the PWLB 20-25 year lower quota rate up to 5.00%-5.15% and it is forecast that this rate will stabilise around 5.00% for most of 2004/05. A rise in long-term PWLB rates to more normal levels with the 20-25 year lower quota rate returning consistently to the band of 5.00%-5.40% looks likely in 2004/05.

Interest Rates

5.6 Having set the scene in economic terms, the likely impact for interest rates can be assessed and is illustrated in the following tables.

Table 1 Sector Treasury - Interest Rate Forecast

(This table represents the view of the Council's Treasury advisors as at December 2003)

%	Current	Q1 2004	Q2 2004	Q3 2004	Q4 2004
Base Rate	3.75	4.00	4.00	4.25	4.25
10 Year PWLB	5.00	5.00	5.00	5.00	5.00
25 Year PWLB	4.90	4.75	5.00	5.00	5.00

Table 2 Summary of Independent Forecasts of Base Rate

(This table represents the views of 35 independent forecasters views of base rate as at November 2003)

%	2004 Year end	2005 average	2006 average	2007 average
Average	4.27	4.78	5.05	4.93
Highest	5.00	5.72	5.60	5.60
Lowest	3.14	4.00	3.81	3.84

Table 3 Consensus Forecast on Short-term & 10 year Fixed Interest Rates as at November 2003

(This table represents the views of 25 City institutions)

%		November 2003	February 2004	November 2004
3 Month Interbank	Average	3.88	3.70	4.10
	Highest	3.88	4.00	4.70
	Lowest	3.88	3.50	3.30
10 Year PWLB Rate	Average	5.20	4.85	4.95
	Highest	5.20	5.15	5.55
	Lowest	5.20	4.45	4.25

6. BORROWING STRATEGY

6.1 Based upon the prospects for interest rates outlined above, there are a number of strategy options available. The anticipation is that short-term variable PWLB rates will continue to be cheaper than long-term PWLB fixed rate borrowing during 2004/05. Short term variable rates are expected to rise in line with increases in base rate. Long term rates are not currently expected to move far, but if there were a major fall in share prices (which is not expected given the general expectations for world economic recovery), 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 likely to remain so for potentially at least the next couple of years. Best value will, therefore, be achieved by borrowing short-term at variable rates in order to minimise borrowing costs in the short-term or to make short -erm savings required in order to meet budgetary constraints.

- That Money Market debt will also be considered where opportunities are available to minimise borrowing costs in the short-term. These have recently become more attractive than PWLB rates and, therefore, the County Treasurer will carefully monitor the interest rates available and take advice from the Treasury Management Consultants over the timing of any new borrowing.

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

6.2 Against this background, caution will be adopted with the 2004/05 treasury operations. The County Treasurer will monitor the interest rate market and adopt a pragmatic approach to any changing circumstances.

6.3 **Sensitivity of the forecast** - The main sensitivities of the forecast are likely to be the two scenarios below. 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:

- ***If it was felt that there was a significant risk of a sharp rise in long and short term rates***, perhaps arising from a greater than expected increase in world activity, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

- ***If it was felt that there was a significant risk of a sharp fall in long and short term rates,*** owing to e.g. growth rates remaining low or weakening, then long term borrowings will be postponed, and any rescheduling from fixed rate funding into variable or short rate funding will be exercised.

7. INVESTMENT STRATEGY

Internally Managed Funds

7.1 The County Treasurer manages part of the Council's investment portfolio. Investments managed by the in-house team are generally temporary in nature and short-term. All decisions are made in the light of the Council's forecast cash flow requirements.

7.2 If, during the course of the year, the County Treasurer detects that the market's expectation for base rates has been too high, the strategy will be to keep investments as long as possible with a view to locking in higher rates of return than may be available at a later stage when market expectations are corrected.

7.3 Investment returns are forecast to be less than the cost of new borrowing during most of the year; it may, therefore, be beneficial to finance new capital expenditure by running down cash balances.

Externally Managed Funds

7.4 A cash fund of £6,759,307 (asat 31st December 2003) is managed by Investec Asset Management and the Council's treasury adviser assists in monitoring the cash fund manager's performance during the course of the year. Their performance will continue to be monitored in 2004/05.

8. DEBT RESCHEDULING OPPORTUNITIES

8.1 With variable rate borrowing and fixed borrowing for short periods (e.g. one year) at rates below 4.50%, opportunities may exist for restructuring lon- term debt into short term debt to produce savings. Fixed rates are not expected to rise back up to about 5.25% to 5.50% during 2004/05. Consequentl,y long-term debt rates at or above 4.90% would warrant reviewing the potential for undertaking debt restructuring.

8.2 Money market debt will also be considered as part of debt rescheduling, where opportunities exist to replace high rated PWLB loans with lower rated market debt to produce interest savings over the short term (between one and four years). The County Treasurer will carefully monitor interest rates and take advice from the Treasury Management Consultants over the timing of any debt rescheduling.

8.3 Any positions taken via rescheduling will be in accordance with the strategy position outlined in paragraph 6 above. The reasons for any rescheduling to take place will include:

- The generation of cash savings at minimum risk
- The borrowing strategy outlined above
- A better balance in the maturity profile of the long-term debt portfolio
- A better balance in the ratio of variable to fixed interest rate loans in the long-term debt portfolio.