REPORT NO. 506/03

ANGUS COUNCIL

FINANCE AND INFORMATION TECHNOLOGY COMMITTEE – 15th April, 2003

POLICY AND RESOURCES COMMITTEE – 22nd April, 2003

TREASURY MANAGEMENT STRATEGY STATEMENT – 2003/4

REPORT BY THE DIRECTOR OF FINANCE

ABSTRACT

This report apprises members of the proposed Treasury Management Strategy for Angus Council in 2003/4. The production of a Treasury Management Strategy Statement for the forthcoming year is a requirement of the Treasury Management in the Public Services Code of Practice issued by the Chartered Institute of Public Finance and Accountancy in 2001. The Treasury Management Strategy Statement is submitted for consideration by members with a view to obtaining approval for adoption by the Council. In addition to the foregoing, members should note the requirements of the Treasury Management Policy Statement and Section 15 of the Council's Financial Regulations pertaining to Treasury Management. Members should also note the availability of the Treasury Management Systems Document and the Treasury Management Practices Document. The Treasury Management Systems Document covers detailed systems and procedures within the Treasury Management Section of the Finance Department and the Treasury Management Practices Document sets out the manner whereby the Treasury Management Policies and Objectives may be achieved, managed and controlled.

1. RECOMMENDATION

It is recommended that the Committee agree the adoption of the attached Treasury Management Strategy Statement for implementation within Angus Council. Further, members should note the requirements of the Treasury Management Policy Statement and Section 15 of the Council's Financial Regulations pertaining to Treasury Management. Members should also note the availability of the Treasury Management Systems Document and the Treasury Management Practices Document. The Treasury Management Systems Document covers detailed systems and procedures within the Treasury Management Section of the Finance Department and the Treasury Management Practices Document sets out the manner whereby the Treasury Management Policies and Objectives may be achieved, managed and controlled.

2. INTRODUCTION AND BACKGROUND

The need to prepare a Treasury Management Policy Statement and Treasury Management Strategy Statement is a requirement of the Treasury Management in the Public Services Code of Practice published by the Chartered Institute of Public Finance and Accountancy in 2001. Members are referred to Report Number 786/02 to the Finance and Information Technology Committee dated 18th June, 2002 at which the Code of Practice was adopted for implementation within Angus Council.

3. TREASURY MANAGEMENT STRATEGY STATEMENT

The Treasury Management Strategy Statement sets out the expected treasury activities for the forthcoming financial year and is attached at Appendix 1 for consideration and approval by members.

4. TREASURY MANAGEMENT POLICY STATEMENT AND SUPPORTING TREASURY MANAGEMENT PRACTICES DOCUMENT

The Treasury Management Policy Statement and supporting Treasury Management Practices Document were most recently approved by the Finance and Information Technology Committee dated 18th June, 2002. Since that time the Policy Statement and Practices Document have been strictly adhered to and have resulted in the exercise of stringent financial control within the Treasury Management Section of the Finance Department. Notwithstanding the foregoing, the Policy Statement and Practices Document and their operation within the Treasury Management Section of Finance has been the subject of ongoing monitoring to take account of changing circumstances in this area of activity. Such a review has revealed the operational adequacy and effectiveness of the Policy Statement and Practices Document with no requirement for amendment at this time.

A copy of the existing Treasury Management Policy Statement is attached at Appendix 2 and members should note that the Treasury Management Practices Document is available on demand.

5. CONCLUSION

It is concluded that members should consider and approve the attached Treasury Management Strategy Statement for financial year 2003/4 as attached at Appendix 1.

6. HUMAN RIGHTS IMPLICATIONS

There are no Human Rights Implications arising as a result of this report.

7. CONSULTATION

The Chief Executive and the Director of Law and Administration have been consulted in the preparation of this report.

DAVID S SAWERS
DIRECTOR OF FINANCE

<u>NOTE</u>

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 this report.

Appendix 1

Angus Council - Treasury Management Strategy Statement

The Strategy Statement covers:

- the treasury position at the commencement of financial year 2002/3;
- the treasury limits in force which will limit treasury risk and activities of the Council;
- the prospects for interest rates;
- the borrowing strategy;
- the investment strategy;
- debt rescheduling opportunities.

1. Portfolio Position at the commencement of financial year 2002/3

The Council's total external debt position at the commencement of financial year 2002/3 was, as follows:

			1 April 2002 Total Principal
Fixed Rate Funding	PWLB	£ 104.940 m	
	Market	£ 1.250 m	£ 106.190 m
Variable Rate Funding	PWLB	£ NIL	
	Market	£ 2.523 m	£ 2.523 m
Total External Debt			**£ 108.713 m**
Total Investments - internally managed			£ 10.776 m

The Council's equated external debt position and corresponding equated external interest rate for the financial year 2001/2 was, as follows:

		2001/2 Equated Principal		**2001/2 Equated Rate**	
Fixed Rate Funding	PWLB	£ 103.158 m		6.21 %	
	Market	£ 1.250 m	£ 104.408 m	6.95 %	6.22 %
Variable Rate Funding	PWLB	£ 1.692 m		4.07 %	
	Market	£ 2.906 m	£ 4.598 m	8.16 %	6.65 %
Equated External Debt			**£ 109.006 m**	**6.24 %**	
Equated Investments - internally managed			£ 15.774 m	4.97 %	

2. Treasury Limits for 2003/4

Section 45 of the Local Government and Housing Act, 1989 requires English and Welsh Councils to approve at the commencement of each financial year certain treasury limits. Although this Act only applies to English and Welsh Authorities it is also recommended as good practice for Scotland. Whilst the Director of Finance is empowered to borrow as circumstances require, the limits set by Angus Council as part of its Treasury Policy are, as follows:

- temporary borrowing should not normally exceed 20 per cent of total external borrowing or 25 per cent at the discretion of the Director of Finance or £20 million or £25 million respectively, whichever is less

- long term variable interest rate loans should not normally exceed 25 per cent of long term external borrowing or 30 per cent at the discretion of the Director of Finance

- temporary borrowing and long term variable interest rate loans when taken together should not normally exceed 45 per cent of total external borrowing or 55 per cent at the discretion of the Director of Finance

3. Prospects for Interest Rates

Summary -

Having taken account of a number of current City forecasts for shorter term variable (the base rate or repo rate) and longer term fixed interest rates, Sector Treasury Services (as Treasury Advisers to the Council) have taken the following view with regard to average interest rates for 2003/4:

Base Rate - 3.75 per cent

10 Year Gilt - 4.50 per cent

30 Year Gilt - 4.25 per cent

Notwithstanding the foregoing there is a possibility that base rate could fall to 3.50 per cent for some months during 2003/4 but rise back to 3.75 per cent by the end of the financial year. There is also a possibility that gilt yields between 10 and 30 years could drop to 4.0 per cent for limited periods or, indeed, rise above the rates forecasted should equity values make an unexpected significant recovery.

Background -

In 2001 the United States (US) went through three quarters of recession which was compounded by the terrorist attacks of September 11th. The strong rebound in quarter 1 of 2002 was short lived and faded away in quarter 2. Despite stronger growth in quarter 3, growth weakened again in quarter 4 and is expected to be lack lustre in 2003. As America is the engine house of the world economy, this weak growth has also depressed Eurozone and world growth and trade. The sharp fall in share values as a result of the exposure of corporate accounting scandals in the US during the first half of 2002 and heightened fears of war on Iraq since then have dented the confidence of US consumers. Consumer expenditure, which is the main driving force of the US economy, has suffered as a result.

In contrast the United Kingdom (UK) maintained a healthy average rate of growth in 2001 of 2.0 per cent, albeit under the trend rate of 2.5 per cent. After near stagnation in quarter 4 of 2001 and quarter 1 of 2002, overall UK growth in 2002 fell back to 1.7 per cent and is expected only to recover to 2.2 per cent in 2003. The manufacturing sector was badly hit by the world downturn in 2001 but after recovering well, during the first half of 2002, has weakened again and is heading into recession in 2003 for the third time in 5 years. The economy overall is being supported by strong growth in government expenditure, strong consumer demand and borrowing, strong retail sales and a robust housing market which has underpinned consumer confidence in the face of a plunge in share values. The consumer sector has been fuelled by a strong growth in net (of taxation and mortgages) household income of about 6 per cent in 2002, however, this rate of growth is waning and consumer expenditure is expected to decline correspondingly. Increases in taxation are already in the pipeline so that net income growth will decline to 2.0 per cent in 2003. Consumer expenditure was also supported in 2002 by substantial equity withdrawal but there is a limit as to how much debt consumers can afford. On the negative side, weak world growth and intense competition in domestic markets has undermined corporate profitability, which militates against recovery in the manufacturing sector. This, in turn, has undermined government revenues from corporation tax and income tax, causing a major upward revision in government borrowing over the original forecast in the budget.

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

Shorter term interest rates – Inflationary pressures in 2003/4 are expected to be muted and quarterly RPIX is forecast 2.3 per cent to 2.8 per cent. The cut in base rate in February was justified partially by the need to keep inflation up to the Monetary Policy Committee's (MPC) target of 2.5 per cent in two years time. The MPC has been very concerned at the unsustainably high rate of increase in house prices and at the increase in consumer borrowing which could make borrowers highly sensitive to any increase in interest rates when they finally become necessary. It held base rate unchanged, therefore, for fourteen months until February as it did not want to stimulate the housing market or borrowing by reducing rates. However, despite the above concerns, the overall weak growth outlook is likely to have sparked this rate cut. The US Federal Reserve Bank cut its central rate by 0.5 per cent to 1.25 per cent in November, 2002 to counter prolonged weak economic growth and falling share values (which undermine consumer confidence and, thereby, consumer expenditure). The European Central Bank (ECB) also cut its rate to 2.75 per cent in December, 2002 to counteract weak growth while Japan is still inextricably mired in recession and deflation. The MPC is forecast to maintain the current low level of repo (base) rate to the end of 2003 as a continuing major stimulus to growth. While our central forecast is for base rate to remain unchanged for the remainder of 2003, there are temporary risks to the downside for some months should growth prospects weaken further, before climbing back to 3.75 per cent around the end of the year.

Longer term interest rates – Public Works Loan Board (PWLB) interest rates have been at remarkably low levels in the second half of 2002 and early part of 2003. They are likely to stay there while war fears continue and share prices remain at depressed levels. A consistent rise back to neutral levels (i.e. with the 20-25 year lower quota rate being firmly in the band of 5.0 per cent to 5.375 per cent) looks unlikely in 2003/4. The over riding principle is that there has been a fundamental correction to share values in 2002 due to the elimination of inflated corporate earnings expectations. This was, in turn, due to the exposure of corporate accounting scandals and a much more realistic view of likely earnings in the telecoms and high technology sectors. There appears to be little prospect of a major boost to corporate earnings in 2003/4 in the expected low growth economic environment which would then drive share values back towards their former levels and so reverse the flight to quality (from shares to bonds). The forecast, therefore, for 2003/4 is a continuation of historically very low gilt yields in sympathy with low international government bond yields in this worldwide low growth environment.

There could be other technical factors which overlay existing pressures on longer term interest rates from time to time. Government budgetary deficits are already forecast to be on a rising trend over the next few years as tax revenues have been undermined by weaker economic growth than previously forecast. This could lead to a greater increase than originally expected in gilt issuance which will put more downward pressure on gilt prices i.e. increase yields and, thereby, increase PWLB interest rates.

There may also be additional pressure on gilt yields from pension funds due to the accounting principles of FRS 17 requiring them to match assets to liabilities (although full implementation of the principles of FRS 17 is now unlikely until 2005). This has generated pressure to buy fixed income bonds (primarily corporate bonds) in preference to holding equities and has led to a reduction in pension fund holdings of gilts. Similar pressures have also affected insurance companies which have experienced solvency difficulties due to the huge fall in share values.

4. Capital Borrowings 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 shorter term interest rates will continue to be cheaper than longer term fixed borrowing for most of 2003/4. Shorter term interest rates are expected to be relatively stable at, or near, current levels. Longer term interest rates are not currently expected to move far, however, if there is a major rally in share prices, then longer term interest rates would be susceptible to a corresponding rise.

Against this background the Director of Finance will monitor the interest rate market and adopt a pragmatic approach to any changing circumstances.

Sensitivity of the forecast - 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 circumstance:

- *In the event of an acceleration in growth and an expected rise in longer and shorter term interest rates* - the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are relatively cheap.

- *In the event of a slowdown in growth and an expected fall in longer and shorter term interest rates* - fixed rate borrowings will be postponed (waiting for borrowings to get cheaper) and any rescheduling from fixed rate funding into variable or shorter rate funding will be exercised.

5. Temporary Investments Strategy

It is anticipated that there will be no longer term investments during the course of the year. Temporary investments will be made depending on the amount and duration of surpluses and the structure of interest rates at the time. Investments will be made in accordance with the Approved Investment Regulations (1990) and in accordance with the Treasury Policy Statement.

6. Debt Rescheduling

Any debt rescheduling is likely to take place when fixed interest rates are anticipated to be at their highest, although the situation will be continually monitored in order to take advantage of any perceived anomalies in the yield curve.

Any action taken via rescheduling will be in accordance with the strategy position outlined in Section 4 above.

The reasons for rescheduling will include the following:

- in order to assist the strategy outlined in Section 4 above;

- in order to enhance the balance of the longer term portfolio (amend the maturity profile and / or the balance of volatility); and

- the generation of cash savings at minimum risk.

Angus Council - Treasury Management Policy Statement

Introduction and Background

The need to prepare a Treasury Management Policy Statement is a requirement of the Treasury Management in the Public Services Code of Practice published by the Chartered Institute of Public Finance and Accountancy in 2001. Members are referred to Report Number 786/02 to the Finance and Information Technology Committee dated 18th June, 2002 at which the Code of Practice was adopted for implementation within Angus Council.

The Treasury Management Policy Statement for the Council is, as follows:

- The 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.

- The Council regards the successful identification, monitoring and control of risk to be 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 Council.

- The 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.