Report No 580/04

ANGUS COUNCIL

RESOURCES AND CENTRAL SERVICES COMMITTEE 6 MAY 2004
STRATEGIC POLICY COMMITTEE 11 MAY 2004

TREASURY MANAGEMENT STRATEGY STATEMENT – 2004/5

REPORT BY DIRECTOR OF FINANCE

Abstract: This report apprises members of the proposed Treasury Management Strategy for Angus Council in 2004/5. 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

1.1 It is recommended that the Committee agrees 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

2.1 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 18 June 2002 at which the Code of Practice was adopted for implementation within Angus Council.

3 TREASURY MANAGEMENT STRATEGY STATEMENT

3.1 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 FINANCIAL IMPLICATIONS

4.1 The Treasury Management Policy Statement was most recently approved by the Resources and Central Services Committee dated 23 October 2003. Since that time the Policy Statement has been strictly adhered to and has resulted in the exercise of stringent financial control within the Treasury Management Section of the Finance Department. Notwithstanding the foregoing, the Policy Statement and its 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 with no requirement for amendment at this time.

4.2 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 HUMAN RIGHTS IMPLICATIONS

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

6 CONSULTATION

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

7 CONCLUSION

7.1 It is concluded that Members should consider and approve the attached Treasury Management Strategy Statement for financial year 2004/5 as attached at Appendix 1.

NOTE

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.

SMS

David S. Sawers
Director of Finance

Appendix 1

ANGUS COUNCIL - TREASURY MANAGEMENT STRATEGY STATEMENT

The Strategy Statement covers:

- the treasury position at the commencement of financial year 2003/4;
- 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 2003/4

The Council's total external debt position at the commencement of financial year 2003/4 was, as follows:

		1 April 2003 Total Principal	
Fixed Rate Funding	PWLB	£ 103.940 m	
	Market	£ 1.250 m	£ 105.190 m
Variable Rate Funding	PWLB	£ Nil	
	Market	£ 2.087 m	£ 2.087 m
Total External Debt			**£ 107.277 m**
Total Investments - internally managed			£ 9.000 m

The Council's equated external debt position and corresponding equated external interest rate for the financial year 2002/3 was, as follows:

		2002/3 Equated Principal		2002/3 Equated Rate	
Fixed Rate Funding	PWLB	£ 98.001 m		6.27 %	
	Market	£ 1.250 m	£ 99.251 m	6.95 %	6.28 %
Variable Rate Funding	PWLB	£ Nil		Nil %	
	Market	£ 2.510 m	2.510 m	7.96 %	7.96 %
Equated External Debt			**£ 101.761 m**		**6.32 %**
Equated Investments - internally managed			£ 17.306 m		3.85 %

2. Treasury Limits for 2004/5

It is a statutory duty under Part 7 of the Local Government in Scotland Act, 2003 and supporting regulations for the Council to determine and keep under review how much it can afford to borrow.

In this respect the Council must have regard to the Prudential Code when setting its borrowing limits 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 / Rent Levels is acceptable - Reference Report Number 181/04 to the Special Budget Meeting of Angus Council dated 12th February, 2004.

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 2004/5:

Base Rate - 4.1250 per cent

5 Year Gilt - 4.7500 per cent

10 Year PWLB – 5.0000 per cent

25 Year PWLB - 4.9375 per cent

Notwithstanding the foregoing there is a possibility that base rate could rise more quickly in 2004 if world economic recovery is stronger and faster than forecast. In addition there is a risk that Public Works Loan Board (PWLB) rates between 10 and 25 years could fall by up to 0.50 per cent below the above average forecasts for limited periods if there were exceptional selling pressures on equities.

Background -

America is the economic engine house of the world economy. Economic growth in the United States (US) during 2002 was below trend levels and was then further undermined by the Iraq crisis during the first half of 2003. Since then there has been a major surge in US growth together with an unexpected major pick up of growth in Japan (the world’s second largest economy). There has also been a pick up in consumer and business confidence in the Eurozone though they still remain well below trend levels and the growth rate is still likely to be near zero in 2003. In 2004 economic growth is expected to increase over 2003 in the US, Eurozone, United Kingdom (UK) and Japan.

Forecasts of economic growth rates

	2003	2004
	%	%
World	3.0	3.5
US	2.5	4.6
Japan	2.6	3.4
Eurozone	0.3	1.7
UK	2.0	3.5

In terms of growth rates, as indicated above, it should be noted that newly industrialized Asian economies and other emerging and developing countries (notably China and India) are experiencing greater growth than the world average.

US Outlook - The outlook for the US in 2004 is fragile as the boost to consumer expenditure from tax cuts in 2003 and past mortgage refinancing at lower rates of interest will have come to an end (as longer term interest rates have risen during 2003). There is little prospect of stronger wage growth to boost consumption as the labour market is very weak and is worse than in any previous recovery. In addition house prices are now as over valued as they were at the peak of the housing cycle in the late 1980s, which suggests that house price inflation is likely to fall to zero as it did in the early 1990s. The burgeoning Federal deficit which is likely to increase further to 5 per cent of Gross Domestic Product in 2004 could push up longer term interest rates (due to increases in Government borrowing) and / or lead to increased taxation. In addition the huge balance of payments deficit is likely to increase in 2004. After 3 years of below trend growth there is enough slack in the economy to ensure that inflation is not a problem and oil prices are likely to fall from their current values. This could mean that there is no pressure on the Fed to raise shorter term rates until 2005 despite market expectations of much earlier increases.

UK Outlook - Consumer and business confidence was undermined during the first half of 2003 by the Iraq war. This depressed activity in most sectors of the economy (except the public sector) including the housing market. However, starting in July the housing market gained a second wind and saw a return to significant monthly house price increases although the overall house price inflation rate for 2003 is expected to be “only” about 10 per cent - well down on the 28 per cent of 2002. During the last few years consumers have had a huge appetite for mortgage equity withdrawal and other borrowing stimulated by the lowest borrowing rates for many years. This is a very unbalanced situation, as the economy cannot continue to be propped up indefinitely by such large ongoing increases in borrowing, keeping consumer expenditure buoyant. In addition, growth in households real disposable income has fallen from annual rates of 7 per cent in 2000-2001 to around 2 per cent and is forecast to fall further. Consumer confidence is also tied closely to the state of the housing market - the Bank of England is currently forecasting that house price inflation will slow to a benign level of static house prices within the next 2 years. However, some forecasters are more pessimistic and point to the plummeting level of first time buyer mortgages (as a percentage of total new mortgages) as evidence that house prices are now seriously over valued and heading for a sharp downward correction. The overall expectation is that growth in consumer demand will slow sharply in 2004. However, business confidence is rising which should help investment expenditure recover. Also global recovery is stimulating exports and this should accelerate further in 2004. The huge American balance of payments deficit is likely to prompt a further fall in the value of the dollar and an appreciation of the euro. Sterling is likely to depreciate against most currencies except the dollar, which should help our exports, whilst American economic recovery could lead to an increase in UK exports to America despite the adverse effect of the appreciation of sterling against the dollar. Overall 2004 should see some rebalancing of the UK economy away from consumer expenditure to the external sector.

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

Shorter term interest rates – Although RPIX inflation has been above the Monetary Policy Committee (MPC) target of 2.5 per cent during 2003 to date, inflationary pressures are expected to subside once high oil price and house price increases work their way out of the figures – quarterly RPIX is forecast to average 2.8 per cent to 2.5 per cent in 2004. Base rate was cut by 0.25 per cent in July, 2003 to a new 48 year low of 3.5 per cent due to hesitant recovery after the Iraq war and a climbing pound. With hindsight this now appears to have been an over cautious move by the MPC as this cut was reversed in November. However, the Chancellor has committed himself to announce a switch of inflation target for the MPC in the Pre Budget Report in December, 2003 from plus or minus 1 per cent around 2.5 per cent on RPIX to probably 2 per cent on the Harmonized Index of Consumer Prices (HICP). HICP has been running at 1.1 per cent to 1.6 per cent throughout 2003 and is forecast to average 1.4 per cent in 2003 and 1.7 per cent in 2004 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. There is, therefore, likely to be little inflationary pressure to raise base rate. In addition the upside potential for base rate is limited by the heightened sensitivity of consumers to interest rate rises due to the huge increase in personal borrowing in recent years e.g. an increase in base rate from 3.5 per cent to 4.5 per cent is an increase of 29 per cent in likely borrowing rates. In view of the likely fragility of consumer demand in 2004 in the UK, due 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 per cent by the end of 2004 after remaining at 4 per cent for most of the year.

Longer term interest rates – Public Works Loan Board (PWLB) rates were at low levels in the early part of 2003 as a result of safe haven flows of investment money ((investors selling equities and buying Government bonds (gilts) so causing bond prices to rise and, therefore, bond yields / fixed interest rates to fall)). This consequently depressed Public Works Loan Fund (PWLB) rates below normally expected levels particularly during the period before the Iraq war. Equity values have increased by about 25 per cent to 30 per cent 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, thus boosting corporate earnings. Gilt prices have consequently fallen so causing increases in gilt yields and longer term PWLB rates – these incurred a further sharp unexpected increase in October, 2003 on a surge in optimism on US economic recovery. This pushed the PWLB 25 year lower quota rate up to 5.00 – 5.15 per cent and it is forecast that this rate will stabilize around 5 per cent for most of 2004/5. A rise in longer term PWLB rates to more normal levels - with the 20 to 25 year lower quota rate returning consistently to the band of 5.25 per cent to 5.50 per cent - looks unlikely in 2004/5.
There could be other technical factors that 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 but tax revenues have been undermined by weaker economic growth than previously forecast. This is expected to lead to a greater increase than originally

expected in gilt issues which may put some downward pressure on gilt prices - leading to an increase in gilt yields and, therefore, an increase in PWLB rates.
There may also be additional pressures 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 - especially longer dated gilts. Similar pressures have also affected insurance companies that have experienced solvency difficulties due to the huge fall in share values over the last 3 years.

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 variable Public Works Loan Board (PWLB) rates will continue to be cheaper than longer term PWLB fixed rate borrowing during 2004/5. Shorter term variable rates are expected to rise in line with increases in base rate. Longer 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 longer term rates would be susceptible to a corresponding fall.

In view of the foregoing it is considered that shorter term variable rates will be good value compared to longer term rates and are likely to remain so for potentially at least the next 2 years. Best value will, therefore, be achieved by borrowing shorter term at variable rates in order to minimize borrowing costs in the shorter term.

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 Treasury Management Policy Statement.

6. Debt Rescheduling

With variable rate borrowing and fixed rate borrowing for shorter periods (i.e. up to, and including, 364 days) at rates below 4.5 per cent opportunities may exist for restructuring longer term debt into shorter term debt to produce savings. Fixed rates are not expected to rise back to about 5.25 – 5.50 per cent during 2004/5. Consequently longer term debt rates at, or above, 4.90 per cent would warrant a review of the potential for undertaking debt restructuring. Any position taken via rescheduling will be in accordance with the strategy 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.

Appendix 2

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.