REPORT NO. 375/05

ANGUS COUNCIL

RESOURCES AND CENTRAL SERVICES COMMITTEE – 17th March, 2005

STRATEGIC POLICY COMMITTEE – 22nd March, 2005

TREASURY MANAGEMENT STRATEGY STATEMENT – 2005/6

REPORT BY THE DIRECTOR OF FINANCE

ABSTRACT

This report apprises members of the proposed Treasury Management Strategy for Angus Council in 2005/6. 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.

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
- notes the requirements of the Treasury Management Policy Statement and Section 15 of the Council's Financial Regulations pertaining to Treasury Management
- notes the availability of the Treasury Management Systems Document which covers detailed systems and procedures within the Treasury Management Section of the Finance Department
- notes the availability of the Treasury Management Practices Document which 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 18th 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. TREASURY MANAGEMENT POLICY STATEMENT

4.1 The Treasury Management Policy Statement was most recently approved by the Resources and Central Services Committee dated 21st October, 2004. 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. CONCLUSION

5.1 It is concluded that Members should consider and approve the attached Treasury Management Strategy Statement for financial year 2005/6 as attached at Appendix 1.

6. HUMAN RIGHTS IMPLICATIONS

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

7. CONSULTATION

7.1 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

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 this Report.

Appendix 1

Angus Council - Treasury Management Strategy Statement

The Strategy Statement covers:

- the treasury position at the commencement of financial year 2004/5;
- 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 2004/5

The Council's total external debt position at the commencement of financial year 2004/5 was, as follows:

		1 April 2004 Total Principal	
Fixed Rate Funding	PWLB	£ 96.369 m	
	Market	£ 12.000 m	£ 108.369 m
Variable Rate Funding	PWLB	£ Nil	
	Market	£ 2.004 m	£ 2.004 m
Total External Debt			**£ 110.373 m**
Total Investments - internally managed			£ 8.943 m

The Council's equated external debt position and corresponding equated external interest rate for the financial year 2003/4 was, as follows:

		2003/4 Equated Principal		**2003/4 Equated Rate**	
Fixed Rate Funding	PWLB	£ 98.893 m		6.23 %	
	Market	£ 1.000 m	£ 99.893 m	3.60 %	6.20 %
Variable Rate Funding	PWLB	£ Nil		Nil %	
	Market	£ 2.993 m	£ 2.993 m	6.67 %	6.67 %
Equated External Debt			**£ 102.886 m**		**6.21 %**
Equated Investments - internally managed			£ 8.025 m		3.63 %

2. Treasury Limits for 2005/6

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 189/05 to the Special Budget Meeting of Angus Council dated 10th February, 2005.

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 2005/6:

Base Rate - 4.75 per cent

5 Year Gilt - 4.56 per cent

10 Year PWLB – 4.75 per cent

25 Year PWLB - 4.75 per cent

Economic Background -

United Kingdom (UK) during 2004

The UK Economy remained resilient throughout 2004 mainly due to consumer spending which was boosted by double digit house price inflation. Interest rates were increased from the historical low of 3.5 per cent to the present level of 4.75 per cent. This was justified by the Bank of England on the basis that inflationary pressures were building up over their targeted two year horizon. Inflation actually remained very subdued despite oil hitting record price levels and many market commentators felt that the base rate increases were to control the rampant housing market and spiraling consumer debt. External economic and political factors such as the Iraq war and the Asian Tsunami had relatively little impact.

United Kingdom (UK) looking forward through 2005 and into 2006

As at February, 2005 interest rates are 4.75 per cent and there is considerable debate on whether interest rates have peaked. Sector currently has one further interest rate hike as a central forecast. This is because of the feeling that rates are stimulative at these levels and with inflationary pressures building and the housing market rising one more hike should be all that is needed. It is expected that Gross Domestic Product for 2005 will be just under 3 per cent and inflation will remain subdued but rise gently towards the central target of 2 per cent.

The Housing Market is showing signs of slowing down although the data is mixed. Falls in house prices have been recorded in many areas of the UK and forward looking data such as mortgage approvals have been falling for the past six months. Opinion is divided as to the future of the market with some commentators expecting a 20 per cent fall in prices and others forecasting a soft landing. Naturally this will have an effect on interest rates and Sector has base rates falling through the second half of 2005 and 2006. The knock on effects on the consumer of a falling housing market will also impact rate decisions.

Economic Background -

United States (US) during 2004

After the Fed rate had been kept unchanged at 1 per cent since June, 2003 the Fed finally started a measured pace of rate increases in June, 2004 taking the rate to 2.50 per cent in February, 2005. Weak employment dogged the economy. The dollar suffered a major loss in value against world currencies as a result of the burgeoning Federal budget deficit and the balance of payments deficit hitting a record 5.6 per cent of Gross Domestic Product in Quarter 3 of 2004. However, inflation remained benign surviving the onslaught of higher energy prices and business and consumer confidence began to slowly rebuild.

United States (US) looking forward through 2005 and into 2006

It is expected that the Fed will continue to raise interest rates to 3 per cent by mid 2005 but as the cyclical momentum fades away so too rate increases will also peter out. The balance of payments deficit is expected to grow further in 2005 and growth in 2006 is expected to slow down due to structural weaknesses. Increases in inflation stemming from the weaker dollar are expected to be limited by strong competition which should prevent importers from fully passing on price increases.

Economic Background -

European Union (EU) during 2004

The year was marked by a strengthening euro (especially against the dollar) and weak domestic demand. Growth was, therefore, predominantly export led (except for France) despite the rise in the euro. Unemployment grew to hit 8.9 per cent which was a five year high and which impacted domestic confidence. Gross Domestic Product rose only marginally reflecting the loss of momentum in the recovery.

European Union (EU) looking forward through 2005 and into 2006

The European Central Bank rate was held at 2 per cent for the entirety of 2004 and it is forecast that it will also remain unchanged throughout 2005 although the market is pricing in moderate increases. It is anticipated that the EU growth rate will decline in line with a slowdown in world economic growth with the strong euro dampening exports and domestic demand remaining depressed. The euro is expected to continue to strengthen further throughout the year to reach about $1.50 by Quarter 4 of 2005 – this will help to reduce inflationary pressures as imports will fall in price.

Economic Background -

Far East during 2004

China’s Gross Domestic Product grew by 9.5 per cent in 2004, a rate which has been viewed by some analysts as being unsustainably strong. Opinion is divided as to whether a hard landing is in store for China but there are a number of reasons to take an optimistic view. Historically, economic reforms began to take place in 1977 and annual growth has been consistent at similar high levels. The Government is succeeding in its policy of rebalancing growth by moving away from excessive investment towards consumption and net exports. Fixed investment is, therefore, slowing and retail sales at the end of 2004 were strong. The trade surplus in December was at a record high and is expected to rise as reliance on imported components falls.

Far East looking forward through 2005 and into 2006

A moderate slow down is expected in the Chinese Economy in 2005/6 but growth of 8 per cent or more is expected for several years. Inflationary pressures have been easing from 3.9 per cent in 2004 to a forecast of 2.2 per cent for 2005. The Chinese Currency is currently still pegged to the United States Dollar and there has been considerable international pressure for the breaking of the peg and for a revaluation. Whilst a move to a currency basket is possible, domestic fundamentals do not make a strong case for revaluation at the present time.

Growth in Japan is expected to slow to 1.5 per cent to 2 per cent in the long term. In the short term growth is expected to slow this year although a return to recession is thought to be exaggerated by statistical quirks in Gross Domestic Product data originating from changes in methodologies causing downward revisions. Note that business and consumer confidence surveys have remained upbeat. In trade-weighted terms the value of the Japanese Yen has remained stable. Inflation is also very low and is expected to be around 0.6 per cent in 2006.

Interest Rate Forecasts

Base rate is expected to rise to 5 per cent in Quarter 1 or Quarter 2 of 2005 (nearing peak of cycle) and consequently is expected to fall back in 2005. Longer term – 25 year – Public Works Loan Board borrowing is expected to be around 4.75 per cent.

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 there is not likely to be much difference between shorter term variable PWLB rates and medium and longer term PWLB fixed rate borrowing during 2005/6 provided base rate falls from 5 per cent to 4.75 per cent as expected in Quarter 3 of 2005. Variable rate borrowing will therefore be slightly more expensive than longer term fixed borrowing during Quarter 2 but it is expected to become cheaper in Quarter 1 of 2006 when base rate is forecast to fall to 4.5 per cent. Thereafter variable rate borrowing is expected to become still cheaper during 2006 and so the gap will widen further between longer term fixed and variable rates.

Longer term rates are not currently expected to move significantly in 2005/6 with longer term – 25 year – Public Works Loan Board borrowing expected to be around 4.75 per cent (as indicated in the closing paragraph at Section 3 above).

These interest rate expectations provide a variety of options:

- 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 short term at variable rates in order to minimize borrowing costs in the short term or to make short term savings in order to meet budgetary constraints. If fixed PWLB rates should fall significantly then a suitable trigger point for considering new fixed rate longer term borrowing would be about 4.5 per cent.

- The risks intrinsic in shorter term variable rates are such when compared to historically relatively low longer term fixed funding, which may be achievable in 2005/6, that the Council will maintain a stable longer term portfolio by drawing longer term fixed rate funding at a marginally higher rate than shorter term rates.

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 borrowing rates likely to fall significantly during 2005/6 it will be best to avoid fixed borrowing for short periods (e.g. 1 year). Opportunities may exist for restructuring longer term debt into shorter term variable rate debt to produce savings later in the year particularly once base rate has fallen to 4.5 per cent. Fixed rates are not expected to rise back above 5.25 per cent during 2005/6. Consequently longer term debt rates at or above 4.90 per cent would warrant reviewing the potential for undertaking debt restructuring. Any position taken with regard to rescheduling will be in accordance with the strategy outlined in Section 4 above.

The reasons for rescheduling will include the following:

- in order to fulfil 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.