REPORT TO:	Executive Board Sub-Committee
DATE:	8th September 2011
REPORTING OFFICER:	Operational Director – Finance
TITLE:	Treasury Management 2010/11
WARDS:	All

1.0 PURPOSE OF REPORT

1.1 To review treasury management during 2010/11 in accordance with Halton Borough Council's Treasury Management Policy Statement.

2.0 RECOMMENDED: Approve the actual 2010/11 prudential and treasury indicators in this report and note the annual treasury management report for 2010/11

3.0 SUPPORTING INFORMATION

3.1 The annual review is attached in Appendix 1. 2010/11 proved to be another watershed year for financial markets. Rather than a focus on individual institutions, market fears moved to sovereign debt issues, particularly in the peripheral Euro zone countries. Local authorities were also presented with changed circumstances following the unexpected change of policy on Public Works Loan Board (PWLB) lending arrangements in October 2010. This resulted in an increase in new borrowing rates of 0.75 – 0.85%, without an associated increase in early redemption rates. This made new borrowing more expensive and repayment relatively less attractive

4.0 POLICY IMPLICATIONS

4.1 Credit ratings are one method used by the Council to assess the credit worthiness of counterparties on the approved list for short term investments. During 2010/11, the Council continued to review the suitability of approved counterparties against the Treasury Management Strategy (TMS). Any who fell below the minimum requirements specified by the TMS were placed on hold and no further deposits were made. These restrictions placed a heavy burden on the Council to find a suitable counterparty to invest deposits with whilst maintaining the priority towards Security, Liquidity and Yield.

4.2 During 2010/11, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, can be found in Appendix 2 to this report.

5.0 OTHER IMPLICATIONS

5.1 The Treasury Management function has consistently contributed to the budget and helped to fund local services. In 2010/11, Treasury Management generated £0.468m investment income, principally by locking in long term investments during 2008.

5.2 There are no more long term investments which will generate the returns experienced in previous years. It is anticipated that investment income will reduce significantly in 2011/12 as investment rates continue to produce significantly less returns on investment.

6.0 IMPLICATIONS FOR THE COUNCIL'S PRIORITIES

6.1 **Children and Young People in Halton**

None.

6.2 **Employment, Learning and Skills in Halton**

None.

6.3 **A Healthy Halton**

None.

6.4 **A Safer Halton**

None.

6.5 **Halton's Urban Renewal**

None.

7.0 RISK ANALYSIS

7.1 The main risks associated with Treasury Management are the security of investment, accessing funds when required and the volatility of return. To combat this, the Council operates within a clearly defined Treasury Management Policy and an annual Borrowing and Investment Strategy which sets out the control framework.

8.0 EQUALITY AND DIVERSITY ISSUES

8.1 There are no issues under this heading.

9.0 LIST OF BACKGROUND PAPERS UNDER SECTION 100D OF THE LOCAL GOVERNMENT ACT 1972

Document	Place of Inspection	Contact Officer
Working papers	Financial Management Division	M. Lloyd

HALTON BOROUGH COUNCIL

REVIEW OF TREASURY MANAGEMENT

2010/11

FINANCIAL MANAGEMENT DIVISION
AUGUST 2011

APPENDIX 1

Treasury Management - Annual Review 2010/11

1.0 Introduction and Background

1.1 This Council is required through regulations issued under the Local Government Act 2003 to produce an annual treasury report reviewing treasury management activities and actual prudential and treasury indicators for 2010/11. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

1.2 During 2010/11 the minimum reporting requirements were that the full Council should receive the following reports:

- An annual treasury management and investment strategy in advance of the year (Council 3rd March 2010).
- A mid-year treasury update report (Quarter 2: July-September)
- An annual report following the year describing the activity compared to the strategy (this report).

In addition, Executive Board Sub Committee has received quarterly treasury management update reports detailing treasury management activity throughout the year.

1.3 Recent changes in the regulatory environment place a much greater onus on members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

1.4 Treasury Management is defined as "The management of the Local Authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimal performance consistent with those risks.

1.5 This report summarises:

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- Reporting of the required prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;

- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

2.0 The Council's Capital Expenditure and Financing 2010/11

2.1 The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If there is insufficient financing, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

2.2 The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

£millions	2009/10 Actual	2010/11 Estimate	2010/11 Actual
Non-HRA capital expenditure	33,208	57,054	42,964
Resourced by:			
Supported Capital Expenditure	6,790	4,081	2,138
Capital Receipts/Reserve	3,587	4,502	3,810
Capital Grants and Contributions	13,820	25,755	24,998
Revenue	634	0	971
Unfinanced Capital Expenditure	**8,377**	**22,716**	**11,048**

3.0 The Council's overall borrowing need

3.1 The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's debt position. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend. It represents the 2010/11 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

3.2 Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the

Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

3.3 Reducing the CFR – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision (MRP), to reduce the CFR. This is effectively a repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

3.4 The Council's 2010/11 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2010/11 on the 3rd March 2010.

3.5 The Council's CFR for the year is shown below, and represents a key prudential indicator. This includes leasing schemes on the balance sheet, which increase the Council's borrowing need.

CFR(£millions)	31 March 2010 Actual	31 March 2011 Original Indicator	31 March 2011 Actual
Opening balance	65,012	75,069	78,278
Add supported capital expenditure	6,790	4,081	2,138
Add unfinanced capital expenditure	8,377	22,716	11,048
Add adjustment for the inclusion of leases	890	0	332
Less MRP/VRP	(2,791)	(1,991)	(2,760)
Closing balance	**78,278**	**99,875**	**89,036**

3.6 The borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

3.7 Net borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2010/11 plus the expected changes to the CFR over 2011/12 and 2012/13. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2010/11. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

£millions	31 March 2010 Actual	31 March 2011 Original Indicator	31 March 2011 Actual
Net borrowing position	12,376	20,768	10,426
CFR	78,278	99,875	89,036

3.8 The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2010/11 the Council has maintained gross borrowing within its authorised limit.

3.9 The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

3.10 Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

		2010/11 Actual
Authorised limit	£m	84,660
Maximum gross borrowing position	£m	26,250
Operational boundary	£m	79,660
Average gross borrowing position	£m	20,813
Financing costs as a proportion of net revenue stream	%	2.37

4.0 Treasury Position as at 31 March 2011

4.1 The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2010/11 the Council's treasury position was as follows:

	31st March 2011				31st March 2010		
	Principal £m	£m	Rate %	Ave Life Yrs	Principal £m	Rate %	Ave Life Yrs
Fixed Rate Funding							
- PWLB	10.00		3.70	45	10.00	3.70	46
- Market	10.00	20.00	4.42	55	10.00	4.42	56
Variable Rate Funding							
- PWLB	0.00				0.00		
- Market	0.00	0.00			2.00	0.32	
Total Debt		**20.00**	**4.06**		**22.00**	**3.84**	
CFR		**89.03**			**78.28**		
Over/(Under) borrowing		**(69.03)**	**77.54**		**(56.28)**	**71.90**	
Investments							
- In House	9.55				16.10		
- With Managers	0.00	9.55	1.14		0.00	4.65	
Total Investments		**9.55**	**1.14**		**16.10**	**4.65**	

4.2 The maturity structure of the debt portfolio was as follows:

	31 March 2010 Actual	2010/11 Original Limits	31 March 2011 Actual
Under 12 months	0	50%	0
12 months and within 24 months	0	75%	0
24 months and within 5 years	0	75%	0
5 years and within 10 years	0	75%	0
10 years and above	100%	75%	100%

There was no long term borrowing during 2010/11 to finance the capital programme. Existing PWLB £10.0 million and EuroHypo £10.0 million loans remained the only borrowings to mature in excess of 10 years.

4.3 All investments placed during 2010/11 had a maturity of less than 364 days.

4.4 The exposure to fixed and variable rates was as follows:

	31 March 2010 Actual	2010/11 Original Limits	31 March 2011 Actual
Fixed Rate (Principal)	18%	75%	52%
Variable Rate (Principal)	9%	75%	0%

5.0 The Strategy for 2010/11

5.1 The Council’s Treasury Management Strategy for 2010/11 is attached as Appendix 3 to this report.

5.2 There were changes in expectations of Bank Rate and PWLB rates which were factored into the treasury management operation during 2010/11. There were no revisions to the strategy during the year.

6.0 The Economy and Interest Rates

6.1 UK growth proved mixed over the year. The first half of the year saw the economy outperform expectations, although the economy slipped into negative territory in the final quarter of 2010 due to inclement weather conditions. The year finished with prospects for the UK economy being decidedly downbeat over the short to medium term while the Japanese disasters in March, and the Arab Spring, especially the crisis in Libya, caused an increase in world oil prices, which all combined to dampen international economic growth prospects.

6.2 The change in the UK political background was a major factor behind weaker domestic growth expectations. The new coalition Government struck an aggressive fiscal policy stance, evidenced through heavy spending cuts announced in the October Comprehensive Spending Review, and the lack of any “giveaway” in the March 2011 Budget. Although the main aim was to reduce the national debt burden to a sustainable level, the measures are also expected to act as a significant drag on growth.

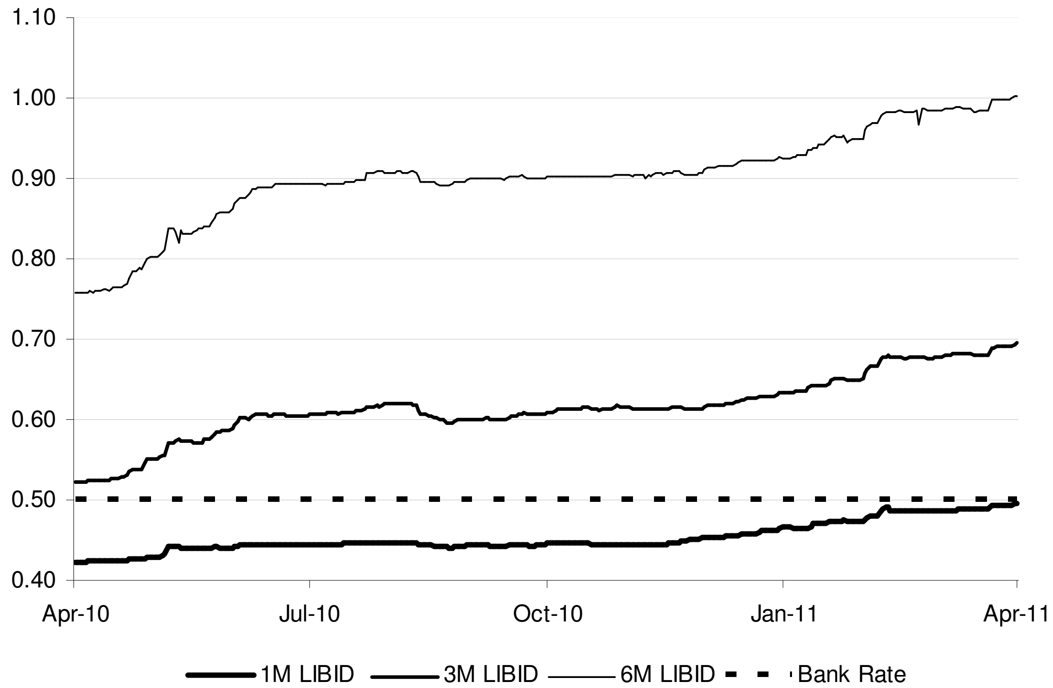
6.3 Gilt yields fell for much of the first half of the year as financial markets drew considerable reassurance from the Government’s debt reduction plans, especially in the light of Euro zone sovereign debt concerns. Expectations of further quantitative easing also helped to push yields to historic lows. However, this positive performance was mostly reversed in the closing months of 2010 as sentiment changed due to sharply rising inflation pressures. These were also expected (during February / March 2011) to cause the Monetary Policy Committee to start raising Bank Rate earlier than previously expected.

6.4 The developing Euro zone peripheral sovereign debt crisis caused considerable concerns in financial markets. First Greece (May), then Ireland (December), were forced to accept assistance from a combined EU/IMF rescue package. Subsequently, fears steadily grew about Portugal, although it managed to put off accepting assistance till after the year end. These worries caused international investors to seek safe havens in investing in non-Euro zone government bonds.

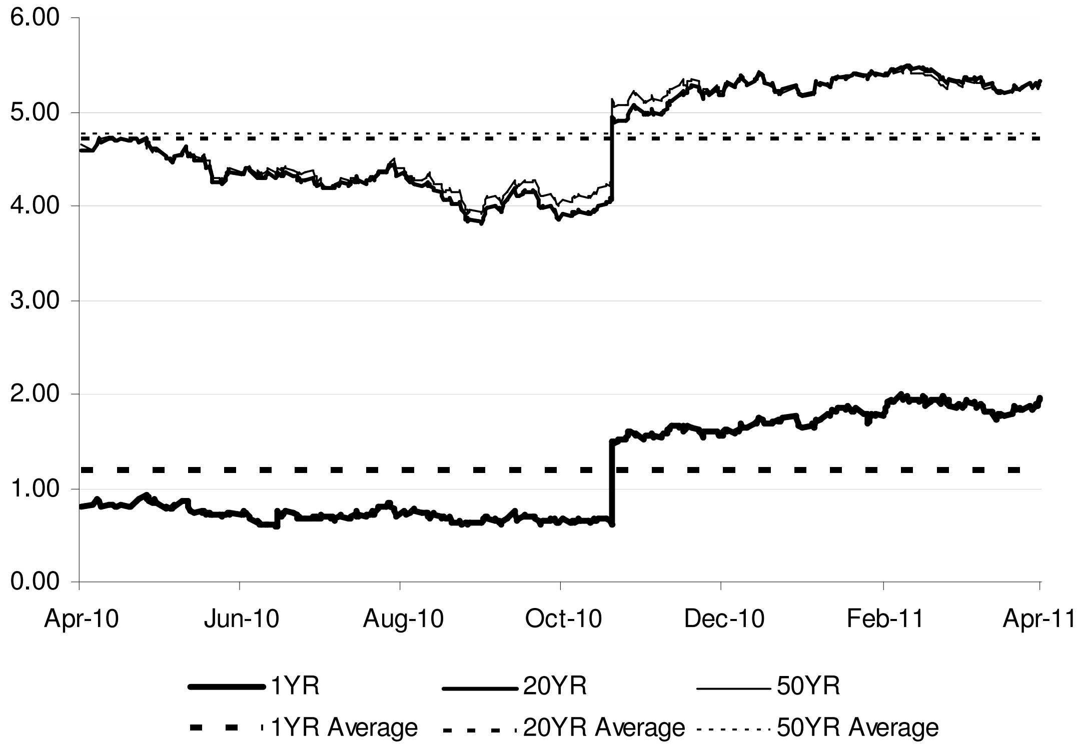
6.5 Deposit rates picked up modestly in the second half of the year as rising inflationary concerns, and strong first half growth, fed through to prospects of an earlier start to increases in Bank Rate. However, in March 2011, slowing actual growth, together with weak growth prospects, saw consensus expectations of the first UK rate rise move back from May to August 2011 despite high inflation. However, the disparity of expectations on domestic economic growth and inflation encouraged a wide range of views on the timing of the start of increases in Bank Rate in a band from May 2011 through to early 2013. This sharp disparity was also seen in MPC voting which, by year-end, had three members voting for a rise while others preferred to continue maintaining rates at ultra low levels.

6.6 Risk premiums were also a constant factor in raising money market deposit rates beyond 3 months. Although market sentiment has improved, continued Euro zone concerns, and the significant funding issues still faced by many financial institutions, mean that investors remain cautious of longer-term commitment. The European Commission did try to address market concerns through a stress test of major financial institutions in July 2010. Although only a small minority of banks “failed” the test, investors were highly sceptical as to the robustness of the tests, as they also are over further tests now taking place with results due in mid-2011.

Bank Rate v LIBID investment rates



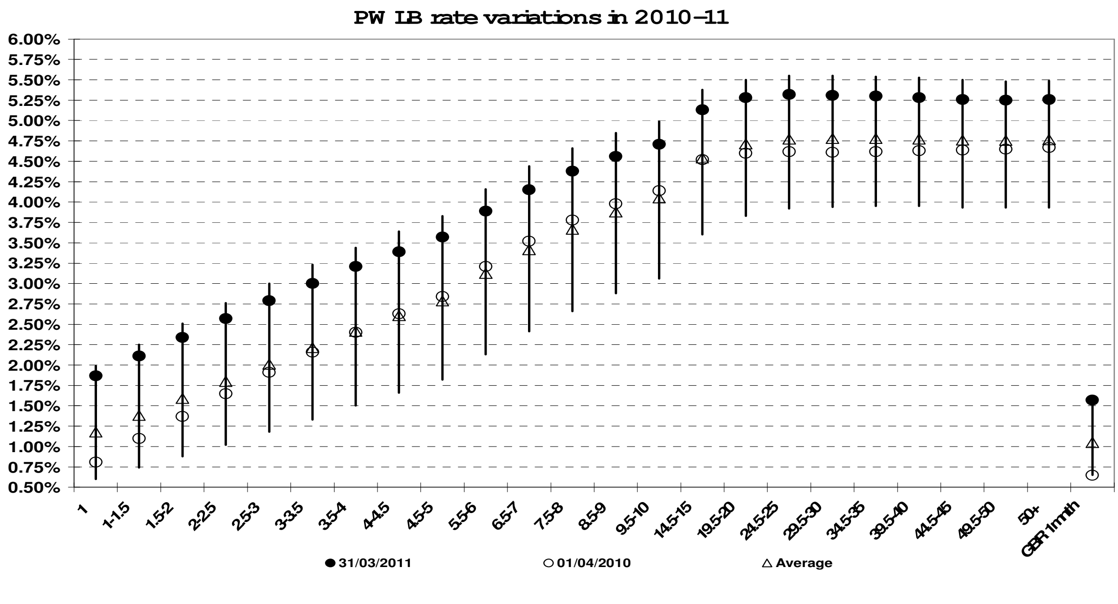
Average v new borrowing rates



6.0 Borrowing Rates in 2010/11

6.1 The graph and table for PWLB maturity rates below show, for a selection of maturity periods, the range (high and low points) in rates, the average rates and individual rates at the start and the end of the financial year.

6.2 Variations in most PWLB rates have been distorted by the October 2010 decision by the PWLB to raise it borrowing rates by about 0.75 – 0.85% e.g. if it had not been for this change, the 25 year PWLB at 31 March 2011 (5.32%) would have been only marginally higher than the position at 1 April 2010.



PWLB BORROWING RATES 2010/11 for 1 to 50 years

	1	1.5-2	2.5-3	3.5-4	4.5-5	9.5-10	24.5-25	49.5-50	1 month variable
01/04/2010	0.810%	1.370%	1.910%	2.400%	2.840%	4.140%	4.620%	4.650%	0.650%
31/03/2011	1.870%	2.340%	2.790%	3.210%	3.570%	4.710%	5.320%	5.250%	1.570%
HIGH	1.990%	2.510%	3.000%	3.440%	3.830%	4.990%	5.550%	5.480%	1.570%
LOW	0.600%	0.880%	1.180%	1.500%	1.820%	3.060%	3.920%	3.930%	0.650%
Average	1.177%	1.590%	2.009%	2.413%	2.788%	4.050%	4.771%	4.756%	1.052%
Spread	1.390%	1.630%	1.820%	1.940%	2.010%	1.930%	1.630%	1.550%	0.920%
High date	07/02/2011	07/02/2011	07/02/2011	07/02/2011	09/02/2011	09/02/2011	09/02/2011	09/02/2011	07/03/2011
Low date	15/06/2010	12/10/2010	12/10/2010	12/10/2010	12/10/2010	31/08/2010	31/08/2010	31/08/2010	01/04/2010

7.0 Borrowing Outturn for 2010/11

7.1 There was no long term borrowing from either the PWLB or market during 2010/11.

7.2 There was no rescheduling of any long term borrowing from either the PWLB or market during 2010/11.

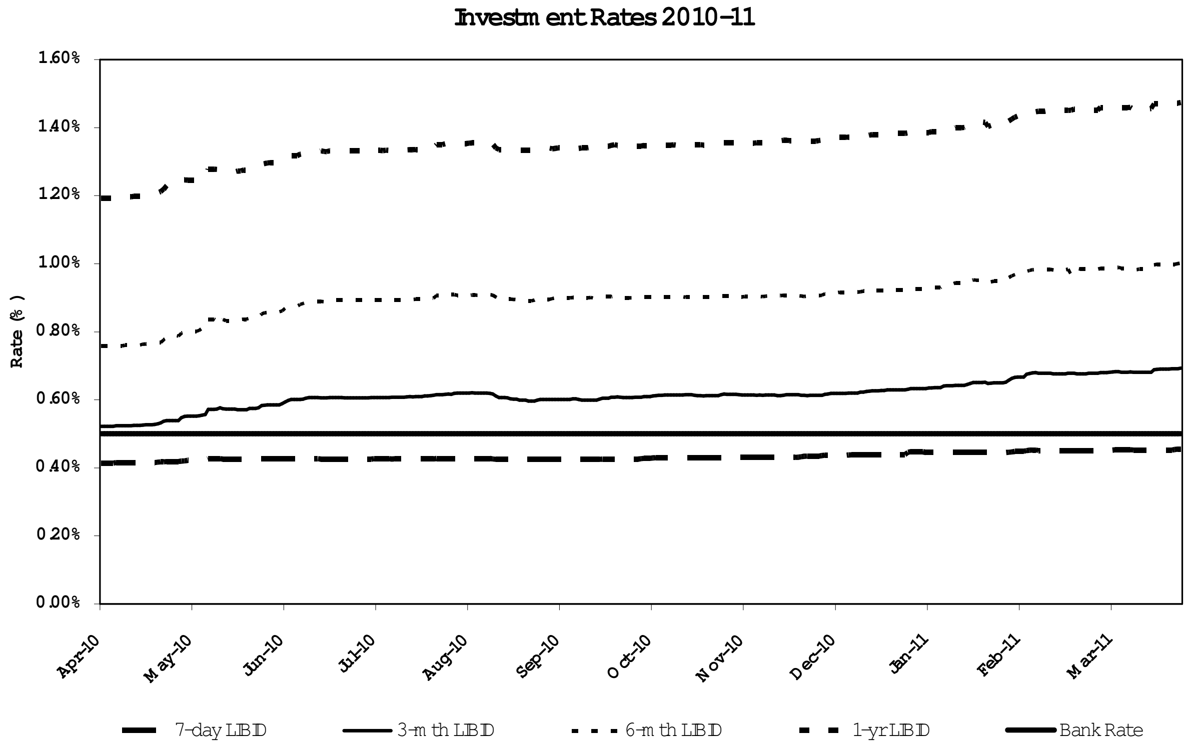
7.3 There was no repayment of any long term borrowing from either the PWLB or market during 2010/11.

8.0 Investment Rates in 2010/11

8.1 The tight monetary conditions following the 2008 financial crisis continued through 2010/11 with little material movement in the shorter term deposit rates. Bank Rate remained at its historical low of 0.5% throughout the year, although growing market expectations of the imminence of the start of monetary tightening saw 6 and 12 month rates picking up.

8.2 Overlaying the relatively poor investment returns was the continued counterparty concerns, most evident in the Euro zone sovereign debt crisis which resulted in rescue packages for Greece, Ireland and latterly Portugal. Concerns extended to the European banking industry with an initial stress testing of banks failing to calm counterparty fears, resulting in a second round of testing currently in train. This highlighted the ongoing need for caution in treasury investment activity.

	Overnight	7 Day	1 Month	3 Month	6 Month	1 Year
01/04/2010	0.41%	0.41%	0.42%	0.52%	0.76%	1.19%
31/03/2011	0.44%	0.46%	0.50%	0.69%	1.00%	1.47%
High	0.44%	0.46%	0.50%	0.69%	1.00%	1.47%
Low	0.41%	0.41%	0.42%	0.52%	0.76%	1.19%
Average	0.43%	0.43%	0.45%	0.61%	0.90%	1.35%
Spread	0.03%	0.04%	0.07%	0.17%	0.24%	0.28%
High date	31/12/2010	30/03/2011	31/03/2011	31/03/2011	31/03/2011	31/03/2011
Low date	01/04/2010	01/04/2010	01/04/2010	01/04/2010	01/04/2010	01/04/2010



9.0 Investment Outturn for 2010/11

9.1 The Council's investment policy is governed by CLG guidance, which was been implemented in the Annual Investment Strategy approved by the Council on 3rd March 2010. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

9.2 The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

9.3 The Council's longer term cash balances comprise, primarily, revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources comprised as follows, and met the expectations of the budget:

Balance Sheet Resources (£m)	31 March 2010	31 March 2011
General Balances	10,559	10,532
Earmarked Reserves	26,833	27,928
Usable Capital Receipts	10,099	8,039
Capital Grants Unapplied	6,004	912
Total	**53,495**	**47,411**

9.4 The Council maintained an average balance of £12.83m of internally managed funds. The internally managed funds earned an average rate of return of 3.66%. The comparable performance indicator is the 7-day LIBID rate which was 0.43%. This compares with a budget assumption of £8.98m investment balances earning an average rate of 1%.

Appendix 2

Prudential and Treasury Indicators 2010/11

A summary of the Prudential and Treasury indicators included in the main body of the report is as follows:

	2009/10 Actual £'000	2010/11 Original £'000	2010/11 Actual £'000
Prudential Indicators			
Capital Expenditure	33,208	57,054	42,964
Ratio of financing costs to net revenue stream	0.67%	2.85%	2.37%
Net borrowing requirement	12,376	20,768	10,426
Capital Financing Requirement as at 31 March	78,278	99,875	89,036
Annual change in Capital Financing Requirement	15,630	24,806	13,086
Incremental impact of capital investment decisions			
Increase in council tax (band D) per annum	1.44	29.61	3.94
Treasury Management Indicators			
Authorised Limit for external debt	70,500	84,660	26,250
Operational Boundary for external debt	65,500	79,660	26,250
Actual external debt	22,000	44,800	20,000
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing/investments	75%	75%	52%
Upper limit for variable interest rate exposure			
Net principal re variable rate borrowing/investments	75%	75%	0%
Upper limit for total principal sums invested longer than 364days			
1-2 years	60%	60%	0%
2-3 years	30%	30%	0%

% **Maturity structure of fixed rate borrowing during 2010/11**	**Upper Limit**	**Lower Limit**
Under 12 months	0%	0
12 months and within 24 months	0%	0
24 months and within 5 years	0%	0
5 years and within 10 years	0%	0
10 years and above	100%	0

Appendix 3

TREASURY MANAGEMENT AND INVESTMENT STRATEGY 2010/11

1.0 INTRODUCTION

1.1 The suggested Treasury Management and Investment Strategy for 2010/11 covers the following aspects of the treasury management function and is based upon the Treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor.

- treasury limits in force which will limit the treasury risk and activities of the Council;
- the current treasury portfolio position;
- the borrowing requirement;
- prospects for interest rates;
- the borrowing strategy;
- policy on borrowing in advance of need;
- the annual investment strategy;
- debt rescheduling;
- minimum revenue provision statement;
- creditworthiness policy
- policy on using external service providers;
- treasury management indicators;
- adopting the revised CIPFA Code of Practice on Treasury Management.

1.2 It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore, means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from: -

1. increases in interest charges caused by increased borrowing to finance additional capital expenditure, and
2. any increases in running costs from new capital projects are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

2.0 TREASURY LIMITS FOR 2010/11

2.1 It is a statutory duty under S.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".

2.2 The Council must have regard to the Prudential Code when setting their 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 is 'acceptable'.

2.3 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.

3.0 CURRENT TREASURY PORTFOLIO POSITION

3.1 This organisation defines its treasury management activities as: "The management of the authority's investments and 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".

This organisation regards the successful identification, monitoring and control of risk to be the 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 organisation.

This organisation 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 value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management."

3.2 The Council’s treasury portfolio position at 25th January 2010 comprised:

		Principal		Average Rate
		£m	£m	%
Fixed Rate Funding	PWLB	10.00		3.70
	Market	10.00	20.00	4.42
Variable Rate Funding	PWLB	0.00		-
	Market	0.00	0.00	-
Total Borrowing			20.00	4.06
Other Long Term Liabilities			0.00	
Total Debt			20.00	
Total Investments			26.95	3.03

4.0 BORROWING REQUIREMENT FOR 2010/11–2012/13

4.1 The table below summarises the net borrowing requirement for the authority for the next three years based on the current level of supported borrowing indicated by the government and prudential borrowing contained in the capital programme.

	2009/10	2010/11	2011/12	2012/13
	£’000	£’000	£’000	£’000
New Borrowing	14,749	24,806	34,863	23,470
Alternative Financing Arrangements	-	-	-	-
Replacement Borrowing*	-	-	-	-
Total	14,749	24,806	34,863	23,470

*4.2 The £10m Lender’s Option Borrower’s Option (LOBO), currently with Euro Hypo bank is on 6 month options (shown as Fixed Rate market above). As such it could fall to be replaced in any of the years.

5.0 PROSPECTS FOR INTEREST RATES

5.1 The Council has appointed Sector Treasury Services as treasury advisor 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 (Bank Rate) and longer fixed interest rates. The following table gives the Sector central view.

Sector Bank Rate forecast for financial year ends (March)

- **2010 0.50%**
- **2011 1.50%**
- **2012 3.50%**
- **2013 4.50%**

There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected. A detailed view of the current economic background is contained within Appendix B to this report.

6.0 BORROWING STRATEGY

6.1 Borrowing rates

The Sector forecast for the PWLB new borrowing rate is as follows: -

	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Mar-12	Mar-13
Bank rate	0.50%	0.50%	0.75%	1.00%	1.50%	3.50%	4.50%
5yr PWLB rate	3.05%	3.20%	3.30%	3.40%	3.60%	4.60%	4.85%
10yr PWLB rate	4.00%	4.05%	4.15%	4.30%	4.45%	5.00%	5.15%
25yr PWLB rate	4.55%	4.65%	4.70%	4.80%	4.90%	5.20%	5.35%
50yr PWLB rate	4.60%	4.70%	4.75%	4.90%	5.00%	5.30%	5.45%

In view of the above forecast the Council's borrowing strategy will be based upon the following information.

- Rates are expected to gradually increase during the year so it should therefore be advantageous to time new long term borrowing for the start of the year when 25 year PWLB rates fall back to or below the central forecast rate of about 4.65%, a suitable trigger point for considering new fixed rate long term borrowing.
- Variable rate borrowing is expected to be cheaper than long term borrowing and will therefore be attractive throughout the financial year compared to taking long term fixed rate borrowing.
- PWLB rates on loans of less than ten years duration are expected to be substantially lower than longer term PWLB rates offering a range of options for new borrowing which will spread debt maturities away from a concentration in long dated debt.
- There is expected to be little difference between 25 year and 50 year rates so therefore loans in the 25-30 year periods could be seen as being more attractive than 50 year borrowing as the spread between the PWLB new borrowing and early repayment rates is considerably less. This would maximise the potential for debt rescheduling and allow the Council to rebalance its debt maturity profile.
- Consideration will also be given to borrowing fixed rate market loans at 25 – 50 basis points below the PWLB target rate and to maintaining an appropriate balance between PWLB and market debt in the debt portfolio.

Sensitivity of the forecast – In normal circumstances the main sensitivities of the forecast are likely to be the two scenarios noted 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 sentiment:

- *if it were felt that there was a significant risk of a sharp FALL in long and short term rates,* e.g. due to a marked increase of risks around relapse into recession or of risks of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.
- *if it were felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,* perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, 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.

6.2 External v Internal borrowing

Comparison of gross and net debt positions at year end	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**
	Actual	**Probable Out-turn**	**Estimate**	**Estimate**	**Estimate**
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
Actual external debt (gross)	40,700	20,000	44,800	79,660	103,130
Cash Balances	(39,000)	(18,000)	(18,000)	(18,000)	(18,000)
Net Debt	**1,700**	**2,000**	**26,800**	**61,600**	**85,130**

- This Council currently has a forecast difference between gross debt and net debt (after deducting cash balances) at the year end of £2m.
- The general aim of the treasury management strategy over the past couple of years has been to reduce the difference between the two debt levels, in order to reduce the credit risk incurred by holding investments. By taking this measure throughout the last year, it has reduced substantially the level of credit risk so another factor which will be carefully considered is the difference between borrowing rates and investment rates to ensure the Council obtains value for money once an appropriate level of risk management has been attained to ensure the security of its investments.
- The next financial year is expected to be one of historically abnormally low Bank Rate. This provides a continuation of the current window of opportunity for local authorities to fundamentally review their strategy of undertaking new external borrowing.
- Over the next three years, investment rates are therefore expected to be below long term borrowing rates and so value for money considerations would indicate that value could best be obtained by avoiding new external borrowing and by using internal cash balances to finance new capital expenditure or to replace maturing external

debt (this is referred to as internal borrowing). This would maximise short term savings.

- However, short term savings by avoiding new long term external borrowing in 2010/11 will also be weighed against the potential for incurring additional long term extra costs by delaying unavoidable new external borrowing until later years when PWLB long term rates are forecast to be significantly higher.
- The Council has examined the potential for undertaking early repayment of some external debt to the PWLB in order to reduce the difference between its gross and net debt positions. However, the introduction by the PWLB of significantly lower repayment rates than new borrowing rates in November 2007 has meant that the reduced discount achieved on the one loan the Council has with the PWLB would not justify the loss of such an excellent long term borrowing deal on value for money grounds. This situation will be monitored in case the differential is narrowed by the PWLB or when repayment rates rise substantially.

Against this background caution will be adopted with the 2010/11 treasury operations. The Operational Director Financial Services will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to the Executive Board Sub-Committee at the next available opportunity. It is likely that the Council's net debt will increase as the capital programme is delivered. To achieve this it may be necessary to borrow short term monies to meet any cash flow needs.

7.0 POLICY ON BORROWING IN ADVANCE OF NEED

7.1 The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Council can ensure the security of such funds.

7.2 In determining whether borrowing will be undertaken in advance of need the Council will;

- ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to take funding in advance of need
- ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow
- consider the merits and demerits of alternative forms of funding
- consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use.

8.0 ANNUAL INVESTMENT STRATEGY

8.1 Investment Policy

The Council will have regard to the CLG's Guidance on Local Government Investments ("the Guidance") issued in March 2004, any revisions to that guidance, the Audit Commission's report on Icelandic investments and the 2009 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities are: -

(a) the security of capital and
(b) the liquidity of its investments.

The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Council is low in order to give priority to security of its investments.

Investment instruments identified for use in the financial year are listed under the 'Specified' and 'Non-Specified' Investments categories. Eligible counterparties and their limits were last reviewed and set by the Executive Board Sub Committee on the 29th January 2009. (Next review January 2011).

Specified v Non Specified investments

There have been an increasing number of innovative investment products being marketed over the past few years. They have arisen due to the relatively low interest rate environment which has prevailed during this period. The initial guidance from the CLG focused on high security and more particularly credit risk. This approach however does not deal with market risk, which is the sudden adverse movement in interest rates. In some products this could lead to a significant diminution of the maturity value below that of the original sum invested.

Because of this it has been suggested that if any investment other than a straight cash deposit is envisaged the following tests are applied ;-

1. the working of the product is fully understood;

2. the degree of risk exposure the product carries is identified;

3. the level of risk fits within the parameters set by the authority;

4. the product complies with the CIPFA Code of Practice on Treasury Management (prime focus on security and best value applied to optimise returns).

The Council has in the main used straightforward cash deposits, with both fixed and variable rates, but always with options to repay if the counterparty wanted to change the terms and agreement couldn't be reached. The issue therefore still boils down to credit risk and this is handled through the counterparty weighted rankings and prudential indicators which limit the amount that can be placed with non rated organisations at any one time.

Specified Investments:

All such investments will be sterling denominated, with maturities up to maximum of 1 year, meeting the minimum 'high' rating criteria where applicable (i.e. credit rated counterparties).

	Minimum 'High' Credit Criteria	Use
Debt Management Agency Deposit Facility	--	In-house
UK Government Gilts	UK Only (AAA)	In house
Bonds Issued by an Institution guaranteed by the UK government	UK Only (AAA)	In house
Term Deposits – UK Government	--	In-house
Term Deposits – Other LAs	--	In-house
Term Deposits – Banks and Building Societies	On Approved List and Rated AA or above	In-house

If forward deposits are to be made, the forward period plus the deal period should not exceed one year in aggregate.

Non-Specified Investments:

A maximum of 30% will be held in aggregate in non-specified investments for 2-3 years and 60% in 1 to 2 years. This group can include non credit rated organisations but with caution.

	Minimum Credit Criteria	Use	Max % of Total Investments	Max. Maturity Period
Term deposits – UK government (with maturities in excess of 1 year)	-	In-house	30% 60%	2-3 years 1-2 years
Term deposits – other LAs (with maturities in excess of 1 year)	-	In-house	30% 50%	2-3 years 1-2 years
Term deposits – banks and building societies (with maturities in excess of 1 year)	On Approved List and less than AA or Unrated.	In-house	30% 60%	2-3 years 1-2 years

The Council uses Moody's ratings to derive its criteria. Where the counterparty does not have a Moody's rating, the equivalent Fitch rating will be used. All credit ratings will be monitored on a regular basis. The Council is alerted to changes in credit ratings through its use of the Sector creditworthiness service. If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

8.2 Investment Strategy

In-house funds: The Council's in-house managed funds have during the past twelve months (January to December) been in the value range of £26.95m to £50.55m with a core balance of around £18m which is available for investment over a longer (say) 2-3 year period. The current balance is £26.95m. Investments will accordingly be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

The Council already has investments that span the financial year e.g. longer-dated deposits, which were taken out at various peaks of the last rate cycles as shown below.

	Amount (£000)	Maturity	Rate (%)
Newcastle BS	2,500	07/06/2010	6.53
Northern Rock Plc	2,500	23/07/2010	6.41
Skipton BS	5,000	03/11/2010	6.15
Barclays Plc	5,000	09/12/2010	2.20

Despite more attractive rates being available for longer periods, it is unlikely that further long dated investments will be undertaken at the present time or until the above investments mature or rates improve.

The interest rate outlook is particularly relevant to the performance of the Council's investment portfolio. Appendix 'A' shows quite clearly that rates are forecast to rise in the next financial year. The timing of any increase will be subject to the speed of any economic recovery. The Council has already placed as much of it's current portfolio into fixed rate, fixed period deals as it feels it can do within the current risk spread policy and cash flow requirements. The current policy will continue to be that of running down the level of investments, to reduce counterparty and interest rate exposure whilst waiting for the opportune time to borrow to fund its long term capital projects. This policy will minimise the impact of low investment rates.

For its cash flow generated balances, the Council will seek to utilise its business reserve account and short-dated deposits (1-3 months) in order to benefit from the compounding of interest.

8.3 End of year Investment Report

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

9.0 DEBT RESCHEDULING

9.1 The introduction of different PWLB rates on 1 November 2007 for new borrowing as opposed to early repayment of debt, and the setting of a spread between the two rates (of about 40 – 50 basis points for the longest period loans narrowing down to 25 – 30 basis points for the shortest loans), has meant that PWLB to PWLB debt restructuring is now much less attractive than before that date. However, significant interest savings may still be achievable through using LOBOs (Lenders Option Borrowers Option) loans and other market loans if these become available after the drying up of their supply during autumn 2008.

9.2 Due to short term borrowing rates being expected to be considerably cheaper than longer term rates, there are likely to be significant opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of their short term nature and the likely cost of refinancing those short term loans, once they mature, compared to the current rates of longer term debt in the existing debt portfolio. Any such rescheduling and repayment of debt is likely to cause a rebalancing of an authority's debt maturities towards a flattening of the maturity profile as in recent years there has been a skew towards longer dated PWLB.

Consideration will also be given to the potential for making savings by running down investment balances by repaying debt prematurely as short term rates on investments are likely to be lower than rates paid on currently held debt. However, this will need careful consideration in the light of premiums that may be incurred by such a course of action and other financial considerations.

As average PWLB rates in some maturity periods are expected to be minimally higher earlier on in the financial year than later on, there should therefore be greater potential for making marginally higher interest rate savings on debt by doing debt restructuring earlier on in the year. Any positions taken via rescheduling will be in accordance with the strategy position outlined in paragraph 7 above.

9.3 The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings;
- help fulfil the strategy outlined in paragraph 7 above; and
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

9.4 The ability to reschedule debt is limited as the Council only has one PWLB loan, which is at a very good long term rate.

9.5 All rescheduling will be reported to the Executive Board Sub-Committee at the meeting following its action.

10.0 MINIMUM REVENUE PROVISION POLICY STATEMENT 2010/11

10.1 The Council implemented the new Minimum Revenue Provision (MRP) guidance in 2008/09, and will assess their MRP for 2010/11 in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

10.2 The major proportion of the MRP for 2010/11 will relate to the more historic debt liability that will continue to be charged at the rate of 4%, in accordance with option 1 of the guidance. Certain expenditure reflected within the debt liability at 31st March 2010 will under delegated powers be subject to MRP under option 3, which will be charged over a period which is reasonably commensurate with the estimated useful life applicable to the nature of expenditure, using the equal annual instalment method. For example, capital expenditure on a new building, or on the refurbishment or enhancement of a building, will be related to the estimated life of that building.

10.3 Estimated life periods will be determined under delegated powers. To the extent that expenditure is not on the creation of an asset and is of a type that is subject to estimated life periods that are referred to in the guidance, these periods will generally be adopted by the Council. However, the Council reserves the right to determine useful life periods and prudent MRP in exceptional circumstances where the recommendations of the guidance would not be appropriate.

10.4 As some types of capital expenditure incurred by the Council are not capable of being related to an individual asset, asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure. Also, whatever type of expenditure is involved, it will be grouped together in a manner which reflects the nature of the main component of expenditure and will only be divided up in cases where there are two or more major components with substantially different useful economic lives.

A brief explanation of the Minimum Revenue Provision and the options available is contained in Appendix C.

11.0 CREDITWORTHINESS POLICY

11.1 This Council uses the creditworthiness service provided by Sector Treasury Services to assist in keeping a close watch on the credit status of the counter parties on the lend list. This service has been progressively enhanced over the last year and now uses a sophisticated modelling approach with credit ratings from all three rating agencies -

Fitch, Moodys and Standard and Poors, forming the core element. However, it does not rely solely on the current credit ratings of counterparties but also uses the following as overlays: -

- credit watches and credit outlooks from credit rating agencies
- CDS spreads to give early warning of likely changes in credit ratings
- sovereign ratings to select counterparties from only the most creditworthy countries

This modelling approach combines credit ratings, credit watches, credit outlooks and CDS spreads in a weighted scoring system for which the end product is a series of colour code bands which indicate the relative creditworthiness of counterparties. The Council is satisfied that the daily update service provided by Sector helps it to monitor the level of security for its investments on a much closer basis. It is also a service which the Council would not be able to replicate using in house resources.

This Council will not use the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine creditworthy counterparties as Moodys are currently very much more aggressive in giving low ratings than the other two agencies. This would therefore be unworkable and leave the Council with few banks on its approved lending list. The Sector creditworthiness service does though, use ratings from all three agencies, but by using a scoring system, does not give undue preponderance to just one agency's ratings.

All credit ratings will be monitored on a daily basis**.** The Council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service.

- If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- In addition to the use of Credit Ratings the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Councils lending list.

Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on government support for banks and the credit ratings of that government support.

11.2 Other issues

Nationalised banks in the UK

Nationalised banks in the UK have credit ratings which do not conform to the credit criteria usually used by local authorities to identify banks which are of high creditworthiness. In particular, as they no longer are separate institutions in their own right, it is impossible for Fitch to assign them an individual rating for their stand alone financial strength. Accordingly, Fitch have assigned an F rating which means that at a historical point of time, this bank failed and is now owned by the Government. However, these institutions are now recipients of an F1+ short term rating as they effectively take on the creditworthiness of the Government itself i.e. deposits made with them are effectively being made to the Government. They also have a support rating of 1; in other words, on both counts, they have the highest ratings possible.

Blanket guarantees on all deposits

Some countries have supported their banking system by giving a blanket guarantee on ALL deposits e.g. Ireland and Singapore. Authorities may view that the sovereign rating of that country then takes precedence over the individual credit ratings for the banks covered by that guarantee. It will be necessary to decide whether to rely on these blanket guarantees to authorise lending to banks covered by these guarantees and for which countries they are related.

UK banking system support package**.**

The UK Government has NOT given a blanket guarantee on all deposits but has underlined its determination to ensure the security of the UK banking system by supporting eight named banks with a £500bn support package. Again, it will be necessary to decide whether to authorise lending to those named banks on the basis of that implicit guarantee on local authority deposits placed with these eight banks or to rely on the credit ratings of the individual banks.

Banks eligible for support under the UK bail-out package: -

- Abbey
- Barclays
- HBOS
- Lloyds TSB
- HSBC
- Nationwide Building Society
- RBS
- Standard Chartered

12.0 POLICY ON THE USE OF EXTERNAL SERVICE PROVIDERS

12.1 The Council uses Sector Treasury Services as its external treasury management advisers.

12.2 The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers. It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

13.0 TREASURY MANAGEMENT INDICATORS FOR 2010/11-2012/13

13.1 The treasury management indicators as set out in Appendix D to this report are relevant for the purposes of setting an integrated treasury management strategy.

14.0 ADOPTING THE CIPFA CODE OF PRACTICE ON TREASURY MANAGEMENT

14.1 The Council is also required to indicate that it has adopted the revised CIPFA code of practice on treasury management. The original 2001 code was adopted in March 2002 and Appendix E to this report summarises the changes contained in the new revised 2009 code.

14.2 It is recommended that the new code is adopted as best practice.

APPENDIX A

INTEREST RATE FORECASTS

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). The final one represents summarised figures drawn from the population of all major City banks and academic institutions.

The forecast within this strategy statement has been drawn from these diverse sources and officers' own views.

1. INDIVIDUAL FORECASTS

Sector interest rate forecast – 23.11.09

	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Bank rate	0.50%	0.50%	0.75%	1.00%	1.50%	2.25%	2.75%	3.25%	3.50%	3.75%	4.25%	4.25%	4.50%
5yr PWLB rate	3.05%	3.20%	3.30%	3.40%	3.60%	3.85%	4.15%	4.55%	4.60%	4.80%	4.80%	4.85%	4.85%
10yr PWLB rate	4.00%	4.05%	4.15%	4.30%	4.45%	4.60%	4.80%	4.90%	5.00%	5.10%	5.10%	5.15%	5.15%
25yr PWLB rate	4.55%	4.65%	4.70%	4.80%	4.90%	5.00%	5.05%	5.10%	5.20%	5.30%	5.30%	5.35%	5.35%
50yr PWLB rate	4.60%	4.70%	4.75%	4.90%	5.00%	5.10%	5.15%	5.20%	5.30%	5.40%	5.40%	5.45%	5.45%

Capital Economics interest rate forecast – 18.1.10

	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%
5yr PWLB rate	3.15%	2.95%	2.65%	2.45%	2.45%	2.45%	2.45%	2.45%
10yr PWLB rate	4.45%	4.15%	3.65%	3.15%	3.15%	3.15%	3.15%	3.15%
25yr PWLB rate	4.75%	4.65%	4.35%	4.05%	3.95%	3.75%	3.75%	3.75%
50yr PWLB rate	4.65%	4.65%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%

UBS interest rate forecast (for quarter ends) – 30.10.09

	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11
Bank Rate	0.50%	0.50%	0.75%	1.00%	1.50%	2.00%	2.50%	3.00%
10yr PWLB rate	3.90%	4.05%	4.40%	4.75%	4.90%	5.15%	5.40%	5.40%
25yr PWLB rate	4.45%	4.65%	5.00%	5.15%	5.40%	5.65%	5.90%	5.90%
50yr PWLB rate	4.55%	4.75%	5.10%	5.25%	5.50%	5.75%	6.00%	6.00%

2. SURVEY OF ECONOMIC FORECASTS

HM Treasury December 2009 – summary of forecasts of 23 City and 12 academic analysts for Q4 2009 and 2010. Forecasts for 2010 – 2013 are based on 21 forecasts in the last quarterly forecast – November 2009.

BANK RATE FORECASTS		quarter ended		annual average Bank Rate			
	actual	Q4 2009	Q4 2010	ave. 2010	ave. 2011	ave. 2012	ave. 2013
Median	0.50%	0.50%	1.30%	0.70%	1.80%	3.00%	3.70%
Highest	0.50%	0.50%	2.30%	1.30%	3.30%	4.30%	4.60%
Lowest	0.50%	0.50%	0.50%	0.50%	0.50%	1.00%	1.40%

APPENDIX B

Economic Background

Introduction

- The credit crunch storm of August 2007 eventually fed through to the near collapse of the world banking system in September 2008. This then pushed most of the major economies of the world into a very sharp recession in 2009 accompanied by a dearth of lending from banks anxious to rebuild their weakened balance sheets. Many governments were forced to recapitalise and rescue their major banks and central banks precipitately cut their central bank rates to 0.10 – 1.00% in order to counter the recession.
- The long awaited start of growth eventually came in quarter 3 2009 in the US and the EU. However, there was disappointment that the UK failed to emerge from recession in quarter 3.
- Inflation has plunged in most major economies and is currently not seen as being a problem for at least the next two years due to the large output gaps and high unemployment putting a lid on wage growth. In many countries there have been widespread pay freezes in 2009 and these are likely to be persistent for some time.
- Deflation could become a threat in some economies if they were to go into a significant double dip recession.
- Asian countries, especially China, are buoying world demand through their own stimulus measures.
- There still needs to be a radical world rebalancing of excess savings rates by cash rich Asian and oil based economies and excess consumption rates in Western economies if the world financial system is not to avoid a potential rerun of this major financial crisis in years to come.
- Most major economies have resorted to a huge expansion of fiscal stimulus packages in order to encourage a fast exit from recession. This, together with expenditure on direct support provided to ailing banks, has led to a drastic expansion in government debt levels which will take many years to eliminate and to restore the previous health of national finances.

Two growth scenarios

- The current big issue is ‘how quickly will the major world economies recover?’ There is a sharp division of opinion on this question as set out below. The knock on effects on forecasts for interest rates can be seen in appendix 2 – UBS strong recovery, Capital Economics – weak recovery.

Strong recovery

- This is a normal cyclical recovery which will be strong in the major world economies. The US still has potential to add further fiscal stimulus in 2010 to ensure that strong recovery continues after the current round of stimulus measures end. Growth in the EU is likely to be strong in 2010 and not require such help.

The UK:

- GDP growth will almost get back to the long term average of about 2.5% in 2011 but is likely to peak in the first half of the year as inventory rebuilding and stimulus measures fade and fiscal contraction kicks in later in the year.
- The economy will rebalance with strong growth in exports and import substitution helped by strong recovery in the EU and the rest of the world.
- Sterling has depreciated by 25% since the peak in 2007 and is likely to stay weak.
- Consumer spending – only a mediocre recovery is expected due to a steady increase in the savings ratio from +5.6% in 2009 to about 8% in 2011 as consumers pay down debt or build cash balances. Consumer incomes will be held down by wage freezes and increases in taxation.
- House price recovery is expected to persist helped by a low Bank Rate for a prolonged period; the peak to trough fall in house prices is now expected to be no more than 20%. House prices to rise by about 6% in 2010, and 3% in 2011; mortgage approvals will rise back to the level of 75 - 80,000 per month needed to ensure a continuation of a trend of rising house prices.
- CPI inflation to peak @ 2.5% in early 2010 after the rise in VAT in January but then to fall to a trough near 1.5% in early 2011 and to stay below 2% for the rest of 2011.
- The current MPC attitude is one of hang on as long as possible before increasing Bank Rate. The aim of this would be to try to ensure that growth gets going at a decent rate and that Bank Rate gets back to 4 – 5% before the next recession and that all assets purchased through QE have been sold off by then. The first Bank Rate increase is expected in Q3 2009.
- If there is a change of Government in 2010 with a more aggressive fiscal approach then this could delay the timing of Bank Rate starting to go up.
- The fiscal deficit is 6.4% of GDP, about £90bn, which is expected to fall at £11bn p.a. over eight years at currently planned rates. This is similar to the peak deficit of 7% in 1990s which was remedied to a surplus of 1.6% in the space of 6 years helped by strong, steady economic growth of 3% p.a. supported by loose monetary policy that compensated for the fiscal squeeze.
- Gilt yields, especially longer term ones, are currently artificially low due to the Bank of England's Quantitative Easing operations. £200bn of gilts, commercial bonds and paper are being purchased under this

scheme which has inflated prices and depressed yields. Once this campaign ends, yields will inevitably rise but will also rise due to the huge level of issuance of new gilts to finance the fiscal deficit. Long gilt yields are therefore forecast to reach 6% during 2011.

- Gilt yields could rise higher if there was a hung Parliament in 2010 or if the fiscal situation deteriorates further.
- The major risk to this scenario would be a lack of supply of bank credit. However, it is felt that the Bank of England is on alert to ensure that this does not happen and would continue various measures to assist the expansion of credit.

Weak recovery

- The current economic cycle is not a normal business cycle but a balance sheet driven cycle. Over borrowed banks, corporates and consumers are focused on shrinking their levels of borrowing to more viable and affordable levels and this balance sheet adjustment will take several years to be effected. Repayment of debt will therefore act as a major head wind to the required increase in demand in the economy. Consequently there will only be weak economic recovery over the next few years after the initial sharp inventory rebuilding rebound fades. GDP growth is forecast to reach only +1.5% in 2011.
- Fiscal contraction will further dampen economic recovery driven by a strong political agenda to accelerate cuts in expenditure and increases in taxation after the general election in 2010.
- The consumer savings ratio will rise so as to eliminate over borrowing and to insure against people losing their jobs during this downturn. This will depress consumer expenditure, the main driver of the UK economy.
- Growth will also be hampered by a reduced supply of credit from weakened banks compounded by weak demand for credit.
- The eventual reversal of Quantitative Easing will take cash out of the economy and reduce demand in the economy.
- Unemployment is likely to rise to near to 3m in 2010 and take years to subside due to weak growth. High unemployment will reduce tax income and increase expenditure on benefits and the costs of local authority services.
- Inflation will not be a threat for several years as the current 6% output gap will take until 2014 to be eliminated.
- However, deflation is a major danger for some years: the major falls in manufacturing prices over the last 12 -18 months have still to feed through to the economy and then to impact wage deflation.
- CPI inflation will blip up over 2% in early 2010 but will then be on a strong downward trend to about -1% in 2011.
- There is no need for the MPC to change Bank Rate from 0.5% in 2010 or 2011 and possibly for 5 years as they will need to counter the fiscal contraction which will dampen demand in the economy.

- Long PWLB rates will <u>FALL</u> from current levels to near 4% in 2010 due to weak economic recovery and minimal inflation so that the real rate of return (net of inflation) on long gilts is healthy at these low levels

Sector view

- Sector recognises that at the current time it is difficult to have confidence as to exactly how strong the UK economic recovery will prove to be. Both the above scenarios are founded on major assumptions and research which could or could not turn out to be correct.
- Sector has adopted a more moderate view between these two scenarios outlined above i.e. a moderate return to growth.
- We do, however, feel that the risks that long term gilt yields and PWLB rates will rise markedly are high.
- There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas: -
    - degree of speed and severity of fiscal contraction after the general election
    - timing and amounts of the reversal of Quantitative Easing,
    - speed of recovery of banks' profitability and balance sheet imbalances
    - changes in the consumer savings ratio
    - rebalancing of the UK economy towards exporting and substituting imports
- The overall balance of risks is weighted to the downside i.e. the pace of economic growth disappoints and Bank Rate increases are delayed and / or lower
- There is an identifiable risk of a double dip recession and deleveraging creating a downward spiral of falling demand, falling jobs and falling prices and wages leading to deflation but this is considered to be a small risk and an extreme view at the current time on the basis of current evidence

APPENDIX C

What is a Minimum Revenue Provision?

Capital expenditure is generally expenditure on assets which have a life expectancy of more than one year e.g. buildings, vehicles, machinery etc. It would be impractical to charge the entirety of such expenditure to revenue in the year in which it was incurred and so such expenditure is spread over several years so as to try to match the years over which such assets benefit the local community through their useful life. The manner of spreading these costs is through an annual Minimum Revenue Provision, which was previously determined under Regulation, and will in future be determined under Guidance.

Statutory Instrument 2008 no. 414 s4 lays down that:

"A local authority shall determine for the current financial year an amount of minimum revenue provision that it considers to be prudent."

The above is a substitution for the previous requirement to comply with regulation 28 in S.I. 2003 no. 3146, (as amended)

Along with the above duty, the Government issued new guidance in February 2008 which requires that a Statement on the Council's policy for its annual MRP should be submitted to the full Council for approval before the start of the financial year to which the provision will relate.

The Council are legally obliged to "have regard" to the guidance, which is intended to enable a more flexible approach to assessing the amount of annual provision than was required under the previous statutory requirements. The guidance offers four main options under which MRP could be made, with an overriding recommendation that the Council should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits. The requirement to 'have regard' to the guidance therefore means that: -

1. Although four main options are recommended in the guidance, there is no intention to be prescriptive by making these the only methods of charge under which a local authority may consider its MRP to be prudent.
2. It is the responsibility of each authority to decide upon the most appropriate method of making a prudent provision, after having had regard to the guidance.

Options Available

Option 1: Regulatory Method

Under the previous MRP regulations, MRP was set at a uniform rate of 4% of the adjusted CFR (i.e. adjusted for "Adjustment A") on a reducing balance method (which in effect meant that MRP charges would stretch into infinity). This historic approach must continue for all capital expenditure incurred in years before the start of this new approach. It may also be used for new capital expenditure up to the amount which is deemed to be supported through the SCE annual allocation.

Option 2: Capital Financing Requirement Method

This is a variation on option 1 which is based upon a charge of 4% of the aggregate CFR without any adjustment for Adjustment A, or certain other factors which were brought into account under the previous statutory MRP calculation. The CFR is the measure of an authority's outstanding debt liability as depicted by their balance sheet.

Option 3: Asset Life Method

This method may be applied to most new capital expenditure, including where desired that which may alternatively continue to be treated under options 1 or 2.

Under this option, it is intended that MRP should be spread over the estimated useful life of either an asset created, or other purpose of the expenditure. There are two useful advantages of this option: -

- Longer life assets e.g. freehold land can be charged over a longer period than would arise under options 1 and 2.
- No MRP charges need to be made until the financial year after that in which an item of capital expenditure is fully incurred and, in the case of a new asset, comes into service use (this is often referred to as being an 'MRP holiday'). This is not available under options 1 and 2.

There are two methods of calculating charges under option 3:

a. equal instalment method – equal annual instalments
b. annuity method – annual payments gradually increase during the life of the asset

Option 4: Depreciation Method

Under this option, MRP charges are to be linked to the useful life of each type of asset using the standard accounting rules for depreciation (but with some exceptions) i.e. this is a more complex approach than option 3.

The same conditions apply regarding the date of completion of the new expenditure as apply under option 3.

APPENDIX D

Prudential Indicators

			2008/09	2009/10	2010/11	2011/12	2012/13
Affordability							
1.	Ratio of financing costs to net revenue stream (estimate) - General Fund	%		1.2	2.8	4.4	6.0
2.	Ratio of financing costs to net revenue stream (actual) - General Fund	%	-0.4				
3.	Incremental impact of capital investment decisions on the Council Tax	£		11.72	29..6	34.13	28.09
Capital Expenditure							
5.	Total capital expenditure (estimate) (see Note) - General Fund Note: These figures will be amended as further allocations and grant approvals are received.	£m		40.4	58.6	46.8	27.8
6.	Total capital expenditure (actual) - Actual	£m	38.5				
Capital Financing Requirement							
7.	Capital Financing Requirement (estimate) - General Fund	£m		75.1	99.9	134.7	158.2
8.	Capital Financing Requirement (actual) - General Fund	£m	60.3				
Treasury Management							
	Adopted CIPFA Code of Practice for Treasury Management						
9.	Authorised limit for external debt	£m		70.5	84.7	108.1	113.1
10.	Operational boundary for external debt	£m		65.5	79.7	103.1	108.1
11.	External debt (actual)	£m	40.7				
12.	Upper limit on interest rate exposure on fixed rate debt	%			75	75	75
13.	Upper limit on interest rate exposure on variable rate debt	%			75	75	75
14.	Maturity structure of borrowing as a percentage of fixed rate borrowing Under 12 months 12 months – 2 years 2 years – 5 years 5 years – 10 years 10 years and above	%			Lower / Higher 0 / 50 0 / 75 0 / 75 0 / 75 0 / 75		
15.	Total principal sums invested for periods longer then 364 days 1-2 years 2-3 years	% %			60 30	60 30	60 30
16.	Maturity Structure of new fixed rate borrowing in previous years		None				