Appendix G

Treasury Management Strategy Statement

1. Introduction

1.1 The Council has customarily considered an Annual Treasury Management Strategy Statement under the requirement of the CIPFA Code of Practice on Treasury Management, adopted by the Council on 20th November 2002. The 2003 Prudential Code for Capital Finance in Local Authorities introduced new requirements for the manner in which capital spending plans are to be considered and approved, including the development of an integrated Treasury Management Strategy.

1.2 The revised CIPFA Treasury Management in the Public Services Code of Practice and Prudential Code still require due regard to be had to the Prudential Indicators set out in Appendix D, when determining the Council's Treasury Management Strategy.

Borrowing Strategy

1.3 The suggested borrowing strategy for 2010/2011 in respect of the following aspects of the treasury management function is based upon the Director of Financial Resources' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury adviser. The strategy covers:

- the past and current treasury position including interest rates;
- the borrowing requirement for 2010/2011;
- an economic forecast, including the outlook for interest rates;
- capital borrowings and borrowing strategy for 2010/2011;
- debt rescheduling.

The Borrowing Strategy is set out in paragraphs 2 to 6 inclusive.

Annual Investment Strategy

1.4 The Annual Investment Strategy comprises:

- investment objectives;
- security of capital: the use of credit ratings and other market intelligence;
- investments defined as capital expenditure;
- provision for credit related losses;
- past performance and current position;
- outlook and proposed investment strategy for 2010/2011;
- end of year report.

The Annual Investment Strategy is set out at paragraphs 7 to 14.

BORROWING STRATEGY

2. The Past and Current Treasury Position including Interest Rates

2.1 Interest Rates 2009/2010

2.1.1 Interest rates have varied only slightly during the current financial year, with the largest movement being in the 10 year period which has moved up 0.88%. Both the shorter and the longer periods show a slight decrease from the start of the year, as shown in the table below:

Loan Type	31st March 2009 %	20th January 2010 %	Difference %
7 Day Notice	0.50	0.25	(0.25)
1 Month	0.96	0.41	(0.55)
PWLB - 1 Year	0.83	0.93	0.10
5 Year	2.56	3.13	0.57
10 Years	3.38	4.26	0.88
25 Years	4.28	4.57	0.29
50 Years	4.58	4.49	(0.09)

The Bank of England Base Rate was reduced from 1.00% to 0.50% on 5th March 2009 where it has remained.

2.1.2 Shorter-term interest rates –The Bank of England is expected to resist increasing the Base Rate for as long as possible to help build up momentum in economic growth for the UK. It is forecast to increase by 0.25% in September 2010 and end the financial year at 1.50%. The risk to this scenario is judged to be that these projected increases will be delayed.

2.1.3 Longer-term interest rates – Public Works Loan Board (PWLB) rates have remained relatively flat throughout 2009/2010. The 1 year PWLB has remained around 1%, while the 25 year and 50 year have hovered around 4.50%.

2.2 Long-term Borrowing 2009/2010

2.2.1 As part of the Treasury Management Policy and Strategy Statement, which was included in the March 2009 Capital Programme report to Council, a benchmark rate of 4.00% was set for all long-term borrowing to be undertaken in 2009/2010.

2.2.2 Long-term borrowing of £5.6 million was required to be replaced in 2008/2009 as a result of 11.75% redeemable stock maturing in November 2008. As PWLB rates were forecast to fall during 2009/2010, a decision was taken not to replace this borrowing at that time.

The Council had a further possible borrowing requirement of £20.0 million due to four 'Lenders Option Borrowers Option' loans (LOBO’s) that were due to rollover in 2009/2010 (details shown below). With a LOBO the lender has the option to vary the rate on the rollover date and the Council can either accept the new rate or repay the loan. The lenders have not exercised their option to vary the rate in respect of these loans so far in 2009/2010, and these loans will continue to the next rollover period.

Start Date	Lender	Amount £m	Period (Years)	Rate %	Rollover Date	Rollover Period
29/09/06	Dexia	5.0	60	4.32	29/09/09	Every 3 Years
21/10/03	Barclays	5.0	40	4.50	21/10/09	Every 6 Months
03/02/06	Dexia	5.0	60	4.37	03/02/10	Every 3 Years
22/02/06	Dexia	5.0	60	4.38	22/02/10	Every 3 Years

2.2.3 The Treasury Management Strategy for 2009/2010 included provision for debt rescheduling as follows: “to secure further early debt redemption when (and if) appropriate opportunities arise. Consequently market conditions will be closely monitored to identify and take advantage of any such opportunities”.

In January 2009, £30.0 million of PWLB loans (with an average rate of 4.20%) were prematurely repaid as part of a debt rescheduling exercise. This was considered opportune as investment rates were averaging 1.80% (and were projected to fall further as the Bank Base Rate was cut to help protect the economy from the recession). Investments were therefore used to temporarily finance this transaction as the net premium involved was very advantageous, being almost cost neutral. The aim was then to replace the loans in 2009/2010 in a range of tranches at various maturity periods over the short to medium term to mitigate against any interest rate risk in the future. All replacement loans were taken out with regard to the Council’s target borrowing rate of 4% or below, thus reducing the overall interest charged to the Council.

These loans have now been replaced and are shown in the table below:

Date	Lender	Loan No	Amount £’m	Period (Years)	Rate %	Difference from Benchmark of 4%
18/06/09	PWLB	495591	5.0	3.0	2.32	1.68
18/06/09	PWLB	495595	5.0	4.0	2.73	1.27
22/06/09	PWLB	495612	5.0	9.0	3.67	0.33
30/06/09	PWLB	495648	5.0	10.0	3.71	0.29
10/08/09	PWLB	495784	4.0	8.5	3.65	0.35
10/08/09	PWLB	495785	4.0	11.5	3.99	0.01
13/10/09	PWLB	496090	2.0	18.5	3.99	0.01
Total			**30.0**			
13/10/09	PWLB	496090	3.0	18.5	3.99	0.01
Total Borrowed			**33.0**			

The £33 million replacement borrowing from the PWLB was at an average rate of 3.414%.
A total of £30 million of these loans (with an average rate of 3.356%) were to replace the £30 million of PWLB that was prematurely repaid at an average rate of 4.2%. This will result in annual savings of £252,200 per annum for at least the next 3 years.
The remaining £3 million borrowed (at 3.99%) was to partly replace the £5.6m 11.75% stock which matured in November 2008 and this will result in annual savings of £232,800.
Interest rates will continue to be monitored to determine the optimum time to replace the remaining £2.6 million loan stock with new PWLB borrowings.

On 12th January 2010 a further rescheduling exercise was undertaken when £24.0 million of PWLB loans with an average rate of 4.2% were prematurely repaid, which was almost cost neutral, incurring a minimal cost of £288. These loans are shown below:

Date	Lender	Loan No	Amount £m	Period (Years)	Rate %	Premium / (Discount) £
12/01/10	PWLB	490872	4.0	45.0	4.15	(46,699)
12/01/10	PWLB	490873	4.0	46.0	4.15	(47,065)
12/01/10	PWLB	491674	3.0	46.0	4.20	(5,908)
12/01/10	PWLB	491675	3.0	47.0	4.20	0
12/01/10	PWLB	491676	3.0	48.0	4.20	0
12/01/10	PWLB	491695	3.0	48.0	4.30	60,144
12/01/10	PWLB	491876	4.0	47.0	4.25	39,816
Total Repaid			**24.0**			**288**

This action was considered opportune as investment rates were averaging 0.8% and the average interest payable on the PWLB loans was on average 4.2%, it was therefore considered prudent and appropriate to repay certain higher interest rated PWLB loans using investments to temporarily finance this transaction as the net premium involved was very advantageous, being almost cost neutral. This will result in annual savings of £817,000. The aim is then to replace the loans in 2010/2011 or in future years by replacing the debt on a lower term or with variable rate debt prior to securing lower long term rates at some point in the future, depending upon the financial market outlook.

It is intended to temporarily fund the loans repaid by the use of investments as the current return on investments is much lower than the 4.2% interest that was being paid on these loans.

The Treasury Management team will continue to monitor market conditions and will secure further early debt redemption when and if appropriate opportunities arise. Any rescheduling undertaken will be reported to Cabinet as part of the current treasury management reporting procedure.

2.2.4 The Council also has nine market Lender's Option / Borrower's Option (LOBO) loans totalling £39.5 million. Of these £34.5 million were converted from stepped rate loans (i.e. loans where the interest rate was fixed for an initial period, and then rose to an agreed higher rate) to flat rate loans (sometimes known as vanilla LOBO's) where the interest rate remains the same throughout the period of the loan. The rescheduling of these LOBO's had the following effects:

- Lengthening the period of the loan resulting in a lower interest rate;
- Reducing the Council's volatility levels by lengthening the 'roll-over' period from every six months to every three years.

The one unchanged LOBO detailed below, stepped up to the higher rate of 4.50% from the initial rate of 2.55% on 23rd April 2007.

Start Date	Lender	Amount £m	Period (Years)	Rate %	Fixed Period	Roll Over Period
21/10/03	Barclays	5.0	40	4.5	23/04/07	Every 6 months

The last 'roll-over' date (21st October 2009) has now passed without the lender requesting a change in the rate of interest. The Lender still has the option at the end of each 'roll-over' period to vary the interest rate and the Council has the option to accept the new rate or repay the loan at that point.

The Treasury Management team will continue to monitor this loan for an opportunity to renegotiate the loan in a similar manner to the other LOBO's.

2.3 **Current Portfolio Position**

The Council's treasury portfolio position at 22nd January 2010 is:

		Principal (£m)	Total (£m)	Average Rate (%)
Borrowing				
Fixed Rate Funding	PWLB	107.5		
	Market	24.5		
	Other	0.4	132.4	3.95
Variable Rate Funding	PWLB	0.0		
	Market	15.0		
	Temporary/ Other	30.9	45.9	1.70
Total Borrowing			**178.3**	**3.37**
Total Investments	In House		**164.3**	**1.93**
Net Debt			**14.0**	

This Council currently has a difference between gross debt and net debt (after deducting cash balances), of £14.0 million.

2.4 There are a number of risks and benefits associated with having both a large amount of debt whilst at the same time having a considerable amount of investments.

Benefits of having a high level of Investments are;

- liquidity risk – having a large amount of investments means that the Council is less at risk should money markets become restricted or less available.- this mitigates against liquidity risk;
- interest is received on investments which helps the Council to address its Strategic Priorities;
- the Council has greater freedom in the timing of its borrowing as it can afford to wait until the timing is right rather than be subject to the need to borrow at a time when interest rates are not advantageous.

Risks associated with holding a high level of Investments are;

- the Counterparty risk – institutions can not repay the Council investment placed with them;
- interest rate risk – the rate of interest earned on the investments will be less than that paid on debt, thus causing a loss to the Council.

The Council has mitigated these risks by formulating its Treasury Management Policy that incorporates both a Borrowing Strategy and an Annual Investment Strategy and has also taken prudent action to redeem debt early using investments temporarily to the benefit of the Council by saving on interest charges particularly over the past two financial years.

3. Borrowing Requirement 2010/2011

3.1 Future Borrowing Requirement

		2010/11 £m	2011/12 £m	2012/13 £m
1.	Unsupported Capital Borrowing (potential)	14.0	10.0	10.0
2.	Replacement borrowing (PWLB)	26.5	0.0	5.0
3.	Replacement borrowing (Market)	0.0	0.0	0.0
4.	Market LOBO replacement (potential)	10.0	19.5	20.0
TOTAL – KNOWN (2+3)		**26.5**	**19.5**	**25.0**
TOTAL – POTENTIAL (1+4)		**24.0**	**29.5**	**35.0**

4. The Outlook for Interest Rates

4.1 The Council has appointed Sector Treasury Services as treasury advisers to the Council and part of their service is to assist the Council to formulate a view on interest rates.

4.2 **Economic Forecasts**

Set out below, are a number of current city forecasts for short-term or variable (the Bank of England Base Rate) and longer fixed interest rates.

4.2.1 **Survey of Economic Forecasts**

The table below shows the HM Treasury – December 2009 summary of forecasts of 23 City and 12 academic analysts for Q4 2009 and Q4 2010. Forecasts for 2010 to 2013 are based on 31 forecasts in the last quarterly forecast (January 2010):

Bank Rate Forecast		Quarter ended		Annual Average Bank Rate			
	Actual %	Q4 2009 %	Q4 2010 %	Average 2010 %	Average 2011 %	Average 2012 %	Average 2013 %
Median	0.50	0.50	1.30	0.70	1.80	3.00	3.70
Highest	0.50	0.50	2.00	1.30	3.30	4.30	4.60
Lowest	0.50	0.50	0.50	0.50	0.50	1.00	1.40

4.2.2 Sector's interest rate forecast of 11th January 2010 is set out below:

	2009/10	2010/11				2011/12				2012/13			
	Mar 2010 %	Jun 2010 %	Sept 2010 %	Dec 2010 %	Mar 2011 %	Jun 2011 %	Sept 2011 %	Dec 2011 %	Mar 2012 %	Jun 2012 %	Sept 2012 %	Dec 2012 %	Mar 2013 %
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
PWLB 5yr	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
PWLB 10 yr	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
PWLB 25y	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
PWLB 50yr	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

4.2.3 Capital Economics interest rate forecast of 5th November 2009 is set out below

	2009/10	2010/11				2011/12		
	Mar 2010 %	Jun 2010 %	Sept 2010 %	Dec 2010 %	Mar 2011 %	Jun 2011 %	Sept 2011 %	Dec 2011 %
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
PWLB 5yr	2.35	2.15	2.15	2.15	2.15	2.15	2.15	2.15
PWLB 10 yr	3.45	3.15	2.65	2.65	2.65	2.65	2.65	2.65
PWLB 25y	3.85	3.75	3.75	3.75	3.75	3.75	3.75	3.75
PWLB 50yr	4.15	4.05	4.05	4.05	4.05	4.05	4.05	4.05

4.2.4 UBS interest rate forecast of January 2010 is set out below

	2009/10	2010/11				2011/12		
	Mar 2010 %	Jun 2010 %	Sept 2010 %	Dec 2010 %	Mar 2011 %	Jun 2011 %	Sept 2011 %	Dec 2011 %
Bank Rate	0.50	0.50	0.75	1.00	1.50	2.00	2.50	3.00
PWLB 5yr	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
PWLB 10 yr	3.90	4.05	4.40	4.75	4.90	5.15	5.40	5.40
PWLB 25y	4.45	4.65	5.00	5.15	5.40	5.65	5.90	5.90
PWLB 50yr	4.55	4.75	5.10	5.25	5.50	5.75	6.00	6.00

4.3 Economic Background

4.3.1 Introduction

- The global credit crunch,of August 2007 almost led to the near collapse of the world banking system in September 2008. This then had the effect of pushing most of the major economies of the world into a very sharp recession in 2009, which was 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 with the consequence that most central banks around the world agreed to cut their central bank rates to between 0.10% – 1.00% in order to help counter the ensuing world recession.
- The long awaited start of growth eventually came through in quarter 3 of 2009 in the US and the EU. However, there was disappointment that the UK failed to emerge from recession until quarter 4. Figures released on 26th January 2010 showed that the UK emerged from the recession in Quarter 4 of 2009, but only by the slenderest of margins, by 0.1%. This shows that the recovery is still quite fragile.
- 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 which will have the effect of curbing wage growth. In many countries there have been widespread pay freezes in 2009 and these are likely to be persistent for some time.
- Most analysts think that 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 to avoid a potential repeat of this type of financial crisis in the future.
- Most major economies have resorted to an expansion of fiscal stimulus packages in order to encourage a quicker exit from

recession. This, together with expenditure on direct support provided to ailing banks, has led to a significant increase in government debt levels which will take many years to repay.

4.3.2 **Two growth scenarios**

- The main issue with the world economy at the moment is ‘how quickly will the major world economies recover’ however opinion by financial experts and economists is divided as detailed below: This division of opinion is also reflected in the views of Capital Economics and UBS in the tables above which set out their views on interest rates projected into the future..

4.3.3 **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 is likely to not require such help from EU governments.
- The forecast suggests that UK GDP growth will almost get back to the long term average of about 2.5% by 2011 but growth is likely to peak in the first half of 2010 as inventory rebuilding and stimulus measures begin to fade and some fiscal contraction occurs later in the year.
- In addition it is suggested that 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 reaching its peak in 2007 and is expected to remain weak, which benefits manufacturing industry and exports.
- Consumer spending – only a minimal recovery is expected due to a steady increase in the savings ratio from +5.6% in 2009 to about +8% in 2011 as consumers reduce debt and/or build up cash savings. Consumer spending will also be low due to the fact that both earnings/incomes will be held down by pay freezes or below inflation increases and increases expected in general taxation.
- House price recovery is expected to persist helped by a low Bank Base Rate for a prolonged period. House prices are expected to rise by about 6% in 2010, and 3% in 2011. Mortgage approvals are anticipated to rise back to the level of around 75,000-80,000 per month and this scale of increase is needed to ensure a continuation of a trend of rising house prices.
- CPI inflation was expected to peak at 2.5% in early 2010 after the rise in VAT in January but then to fall to a low of roughly 1.5% in early 2011 and to stay below 2% for the rest of 2011.
- The current MPC attitude is one of restraint and seeking to avoid increasing Bank Base rates for as long as possible to secure economic recovery, the aim being to try to ensure that growth is achieved and well established before Bank Base rates gets back to the level of 4%–5% before the next cyclical recession and that all assets purchased through Quantitative Easing measures have

been sold off by then. The first Bank Base Rate increase is expected in Q3 2010.

- A change of Government in 2010 with a more aggressive fiscal stance could delay the timing of Bank Base Rate increases.
- The UK fiscal deficit is 6.4% of GDP, about £90bn, which is expected to fall at £11bn per annum, over the next eight years at currently planned rates. This is similar to the peak deficit of 7% experienced in the 1990s which was remedied to a surplus of 1.6% in the space of 6 years helped by strong, steady economic growth of 3% per annum and supported by loose government monetary policy that compensated for the fiscal squeeze.

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.

4.3.4 Weak Recovery

- The current economic cycle is not a normal business cycle but a balance sheet driven cycle. Over borrowing by 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 effect. Repayment of debt will therefore act as a major impetus 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 and is forecast to reach only 1.5% maximum growth by 2011.
- Fiscal contraction will further dampen economic recovery driven by a strong political agenda to accelerate cuts in government and public expenditure together with increases in taxation expected 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 the present economic downturn. This will depress consumer expenditure which is the main driver of the UK economy thus limiting expected growth.
- 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 further reduce demand in the economy.
- Unemployment is likely to rise to near 3 million in 2010 and take some years to subside due to expected 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 corrected.
- However, deflation is considered a risk for some years to come as both falls in manufacturing prices over the last 12 -18 months and the impact of wage deflation will still have to feed through to the economy.

- CPI inflation will rise up to 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 the Bank Base Rate from 0.5% in 2010 or 2011 and possibly for the next 5 years as they will need to counter the fiscal contraction that will dampen demand in the economy over this period.
- Long term PWLB rates will fall from current levels to nearer 4% in 2010 due to the weak economic recovery and minimal inflation highlighted above so that the real rate of return (net of inflation) on long dated gilts is considered appropriate at these low levels

4.3.5 Economic summary and review

- 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 large conflicting assumptions and research.
- The Council's treasury advisers have adopted a more moderate view between these two scenarios which is reflected in the economic forecast set out in 4.2.2. and is based upon the following views:
    - The risk that long-term gilt yields and PWLB rates will rise markedly are considered high.
    - There are large uncertainties in both scenarios 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.

In summary, the overall balance of risks is weighted to the downside, with the view that the pace of economic growth disappoints and Bank Rate increases are delayed and / or lower than presently forecast.

There is also a risk that a double dip recession could occur.

4.4 Base Rate Forecast

Sector has advised that they expect the Bank Base Rate to steadily increase over the next three financial years from its current level of 0.50% to 1.50% by March 2011 and to 4.50% by March 2013.

4.5 Long-term PWLB Rates

With regard to the PWLB interest rates, the shorter periods are more influenced by the Base Rate whereas the longer periods are more sensitive to inflation, both actual and expected. Sector is forecasting the PWLB rates to steadily increase throughout 2010/2011 across all periods. The 5 years PWLB is forecast to be 3.6% by March 2011 and the 25 year and 50 year to be around the 5.0% mark.

5. Capital Borrowings and Borrowing Strategy for 2010/2011

5.1 Money markets will no doubt become more volatile in the lead up to the General Election. The Director of Financial Resources will monitor the interest rate market and adopt a pragmatic approach to any changing circumstances, reporting any decisions to Cabinet as part of established reporting procedures for Treasury Management.

5.2 Sensitivities of the Forecast

5.2.1 The main sensitivities of the forecast are likely to be the two scenarios below. Council officers, in conjunction with 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 was felt that there was a significant risk of a sharp rise in long and short term borrowing rates, perhaps arising from a greater than expected increase in world economic activity, then the portfolio position will be re-appraised with the likely action that further fixed rate funding would be drawn whilst interest rates were still relatively cheap.

- If it was felt that there was a significant risk of a sharp fall in long and short term borrowing rates, for example if growth rates remained low or were weakening, then long term borrowings would be postponed, and any rescheduling from fixed rate funding into variable or short rate funding would be considered.

The Director of Financial Resources, taking account of the advice of the Council's treasury adviser considers a benchmark financing rate of 4.50% for any further long-term borrowing for 2010/2011 to be appropriate. With long-term interest rate forecasts set to remain around their current levels that level is considered appropriate as the long-term borrowing rate benchmark limit for 2009/2010.

5.2.2 If long term rates do not fall then consideration will be given to utilising some investment balances to fund the borrowing requirement in 2010/2011. In addition, the Council may not need to borrow further depending upon the evaluation and progress of various capital schemes. However the need to adapt to changing circumstances will be required, and flexibility will be retained to adapt to such changes.

The Director of Financial Resources, taking advice from the Council's treasury advisers will continue to monitor rates closely, and whilst implementing the borrowing strategy, will adopt a pragmatic approach in identifying the low points in the interest rate cycle at which to borrow.

6. Debt Rescheduling

6.1 The reasons for any rescheduling of debt will include:

- the generation of cash savings at minimum risk;
- in order to help fulfil the Treasury Management Strategy; and
- in order to enhance the balance of the long-term portfolio (by amending the maturity profile and/or the balance of volatility).

In previous years debt rescheduling has achieved significant savings in interest charges and discounts and these interest savings have been secured for many years to come. However, changes to the PWLB rules in 2007, in respect of replacement loans significantly impacted upon the potential for debt rescheduling unless significant changes in interest rates are forecast or occur. Such has been the case in the latter part of 2008 and in 2009.

The latest interest rate projections for 2010/2011 show short term borrowing rates will be considerably cheaper than longer term rates. As such 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 lead to a reduction in volatility in the Council's maturity profile as in recent years there has been a skew towards longer dated PWLB. The Council is keeping a watching brief on market conditions in order to secure further early debt redemption when, and if, appropriate opportunities arise. The timing of all debt repayment is crucial. The timing of all borrowing and investment decisions inevitably includes an element of risk, as those decisions are based upon expectations of future interest rates. The policy to date has been very firmly one of risk spread and this will be continued.

6.2 There has been much discussion as to whether the size of spread between long term PWLB repayment and new borrowing rates should be revised (downwards) in order to help local authorities currently dissuaded from using investment cash balances to repay long term borrowing and thereby reduce counterparty and interest rate risk exposure. This has also been highlighted in recent government consultations which emphasise that Councils must not borrow to on-lend and in a recent Debt Management Office (DMO) / PWLB consultation document options were suggested to revise the methodology used to calculate the early repayment rate. The consultation period ended in January 2010 and developments will be monitored to assess if there is any merit in amending the strategy if significant changes are introduced.

6.3 Any rescheduling undertaken will be reported to Cabinet, as part of the agreed treasury management reporting procedure.

ANNUAL INVESTMENT STRATEGY

7. Introduction

7.1 The Council has regard to the Government Guidance on Local Government Investments and the Chartered Institute of Public Finance and Accountancy's (CIPFA's) Treasury Management in Public Services: Code of Practice and Cross Sectoral Guidance Notes (CIPFA TM Code).

7.2 Completion of an Annual Investment Strategy is a requirement under the Government's Guidance on Local Government Investments. The Annual Investment Strategy states which investments the Council may use for the prudent management of its treasury balances during the financial year under the headings of 'Specified Investments' and 'Non-Specified Investments'. Under the prudential code and Government Guidance of Local Government Investments it is possible to use non-specified investments as approved investments. Non-specified investments are for greater than one year (up to a maximum of 5 years), this can present a higher risk than investments for shorter periods.

7.3 This Strategy sets out:

- the procedures for determining the use of each class of investment (advantages and associated risk), particularly if the investment falls under the category of "non-specified investments";
- the maximum periods for which funds may be prudently committed in each class of investment;
- the amount or percentage limit to be invested in each class of investment;
- whether the investment instrument is to be used by the Council's in-house officers and/or by the Council's appointed external fund managers, (if used); and, if non-specified investments are to be used in-house, whether prior professional advice is to be sought from the Council's treasury advisers;
- the minimum amount to be held in short-term investments (i.e. one which the Council may require to be repaid or redeemed within 12 months of making the Investment).

8. Investment Objectives

8.1 All investments will be in pounds sterling. The general policy objective for the Council is the prudent investment of its treasury balances. The Council's investment priorities are in order of importance:

(A) The **security** of capital;
(B) The **liquidity** of its investments and then
(C) The Council aims to achieve the **optimum yield** on its investments but this is commensurate with the proper levels of security and liquidity.

9. Security of Capital: The Use of Credit Ratings

9.1 Sovereign Credit Ratings

One of the recommendations of the Code is that local authorities set limits for the amounts of investments that can be placed with institutions based in foreign countries. Previously investment criteria was based upon the individual credit ratings for institutions. It is therefore recommended that sovereign ratings are applied in the Council's Counterparty criteria as set out in Appendix H.

9.2 Counterparty Criteria and Other Market Intelligence and Information

The Council takes into account not only the credit ratings issued by all three credit rating agencies (Fitch, Moody’s and Standard & Poor’s), but also, all available market data and intelligence, the level of government support to financial institutions and advice from its Treasury Management advisors and has done so for many years.

Set out in Appendix H is the detailed criteria that will be used, subject to approval, in determining the level of investments that can be invested with each counterparty or institution. Where a counterparty is rated differently by any of the 3 rating agencies, the lowest rating will be used to determine the level of investment.

9.3 Monitoring of Credit Ratings:

- All credit ratings are monitored on a daily basis. The Council has access to all three credit ratings agencies and is alerted to changes through its use of the Sector Treasury Services credit worthiness service.

- If a counterparty’s rating is downgraded with the result that it no longer meets the Council’s minimum criteria, the Council will cease to place funds with that counterparty. The Council will also immediately inform its external fund manager(s), if used, to cease placing funds with that counterparty.

- If a counterparty’s rating is downgraded with the result that, their rating is still sufficient for the counterparty to remain on the Approved Lending List, then the counterparty’s authorised investment limit will be reviewed accordingly. A downgraded credit rating may result in the lowering of the counterparty’s investment limit and vice versa. The Council will also immediately inform its external fund manager(s), if used, of any such change(s).

- If fund managers are employed by the Council, the Council will establish with its fund manager(s) their credit criteria and the frequency of their monitoring of credit ratings so as to be satisfied as to their adherence to the Council’s policy.

9.4 Post Credit Crunch Developments

Since the credit crunch crisis there have been a number of developments which require separate consideration and which also help inform the Annual Investment Strategy.

9.4.1 Nationalised / Part Nationalised Banks

In order to stabilise the UK banking system, the UK Government nationalised some banks (Northern Rock and Bradford & Bingley) and took a major shareholding in others (Royal Bank of Scotland (RBS - 84% stake) and Lloyds (43% stake)). These investments by the Government will be managed on a commercial basis by a new arm's-length company, 'UK Financial Investments Limited' (UKFI), which is wholly owned by the Government. Its overarching objectives will be to protect and create value for the taxpayer as shareholder, with due regard to financial stability and acting in a way that promotes competition.

On 1st January 2010 Northern Rock was split into two separate entities; Northern Rock Plc and Northern Rock Asset Management. Northern Rock Plc is the "good bank", according to the Government, and will be regulated by the FSA. It is this bank which will hold local authority deposits. Previously Fitch assigned an Individual Rating of F to Northern Rock, which reflected that this bank had failed and is now owned by the Government. However, since the split of the bank on 1st January 2010 Fitch have not issued an individual or support rating and are currently reviewing their ratings in relation to Northern Rock.

The Government by taking such a large stake in RBS and Lloyds, together with the support packages listed below, have demonstrated their determination not to let these banks fail. As a result of this the Governments AAA rating will be applied to these counterparties with a counterparty limit of £40 million in line with our the credit criteria set out in Appendix H.

9.4.2 UK Banking System - Support Packages

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. Whilst no blanket guarantee is in place this represented a very significant financial commitment which has been accompanied by further statements of intent should a worsening scenario emerge. It is proposed to continue to lend to these eight banks and building societies within the UK, applying a credit rating of AA to these counterparties in recognition of their participation in the Governments support package. As a result of this it is proposed to apply to these counterparties a counterparty limit of £30 million in line with our credit criteria set out in Appendix H

On 13th October 2008, the UK Government announced a further measure known as the Credit Guarantee Scheme. This scheme forms part of the Government's measures announced on 8th October 2008 to ensure the stability of the financial system and to protect savers, depositors, businesses and borrowers. In summary these measures are intended to:

- provide sufficient liquidity in the short term;
- make available new capital to UK banks and building societies to strengthen their resources, permitting them to restructure their finances, while maintaining their support for the real economy; and,
- ensure that the banking system has the funds necessary to maintain lending in the medium term.

As previously stated this Credit Guarantee Scheme is not a blanket guarantee by the UK Government on all deposits but it has underlined the Government's determination to ensure the security of the UK banking system by supporting the banking system with a £500bn support package.

In April 2009 the government introduced it's Asset-backed Securities Guarantee Scheme. The assets eligible for the 2009 Scheme will be residential mortgage-backed securities (RMBS) backed by residential mortgages over property in the UK. HM Treasury will keep the scope of the 2009 Scheme under review. The 2009 Scheme forms part of the Government's measures, announced on 19 January 2009, to support lending in the UK economy, and represents an extension of the 2008 Credit Guarantee Scheme for unsecured debt issuance by UK incorporated banks and building societies (the "2008 Scheme").

In summary, the 2009 Scheme is intended to:

- improve banks' and building societies' access to wholesale funding markets
- help support lending to creditworthy borrowers
- promote robust and sustainable markets over the long term
- protect the taxpayer.

9.4.3 Other Countries

Other countries have also signalled their support for their domestic banks through the provision of very significant financial support and guarantees similar to those provided by the UK Government in relation to its banks.

9.4.4 Sovereign Ratings

The sovereign credit rating of a particular country would take precedence over the individual credit ratings for the banks covered by that guarantee. However a judgement is necessary as to whether to rely on the blanket guarantees to authorise lending to these banks and for which countries they are prepared to do so. The Council, after consultation with it’s Treasury Advisers have decided to only to include countries with a minimum sovereign credit rating of AA+. Furthermore, when determining which country to include, other information will considered such as the Gross Domestic Product (GDP) for that country as well as it’s economic outlook, and the strength of it’s financial system.

10. Investments Defined as Capital Expenditure

10.1 The acquisition of share capital or loan capital in any body corporate is defined as capital expenditure under Section 16(2) of the Local Government Act 2003. Such investments have to be funded out of capital or revenue resources and are classified as ‘non-specified investments’.

10.2 A loan or grant by this Council to another body for capital expenditure by that body is also deemed by regulation to be capital expenditure by the Council. It is therefore important for the Council to clearly identify if the loan has been made for policy reasons or if it is an investment for treasury management purposes. The latter will be governed by the framework set by the Council for ‘specified’ and ‘non-specified’ investments.

10.3 The Council will not use (or allow any external fund managers it may appoint to use), any investment, which will be deemed as capital expenditure.

11. Provisions for Credit Related Losses

11.1 If any of the Council’s investments appear at risk of loss due to default, (i.e. a credit-related loss, and not one resulting from a fall in price due to movements in interest rates), then the Council will make revenue provision of an appropriate amount in accordance with proper accounting practice or any prevailing government regulations, if applicable.

12. Past Performance and Current Position

12.1 During 2009/2010 the Council did not employ any external fund managers, all funds being managed by the in-house team.

The performance of the fund by the in-house team is shown below and compares this with the previous years performance:

	2008/09 Return %	**2008/09 Benchmark %**	**2009/10 Return % Year to date**	**2009/10 Benchmark % Year to date**
Council	5.06	3.60	1.90	0.35

12.2 During 2009/2010 the Council will continue to review the optimum arrangements for the investment of its funds.

13. Outlook and Proposed Investment Strategy 2010/2011

13.1 Based on its cash flow forecasts, the Council anticipates its fund balances in 2010/2011 are likely to range between £150 million and £230 million which represents a cautious approach and provides for funding being received in excess of the level budgeted for and also for unexpected and unplanned levels of slippage and underspending. However in 2010/2011, if short-term interest rates fall materially below long-term rates, it is possible that some investment balances may be used to fund some long-term borrowing or used for debt rescheduling. Such funding is wholly dependent upon market conditions and will be assessed and reported to Cabinet if and when the appropriate conditions arise.

13.2 The Council is not committed to any investments, which are due to commence in 2010/2011, (i.e. it has not agreed any forward deals).

13.3 Activities likely to have a significant effect on investment balances are:

- Capital expenditure during the financial year, (dependent upon timing), will affect cash flow and short term investment balances;
- Any slippage in capital expenditure from, and to, other financial years will also affect cash flow, (no slippage has been taken into account in current estimates);
- Any unexpected capital receipts or income;
- Timing of new long-term borrowing to fund capital expenditure;
- Possible funding of long-term borrowing from investment balances (dependent upon appropriate market conditions).

13.4 The minimum amount of overall investments that the Council will hold in short-term investments (less than one year) is £50 million. As the Council has decided to restrict most of its investments to term deposits, it will maintain liquidity by having a minimum of 40% of these short-term investments maturing within 6 months.

13.5 A maximum limit of £100 million is to be set for in-house non-specified investments over 364 days up to a maximum period of 2 years. This amount has been calculated by reference to the Council's cash flows, including the potential use of earmarked reserves. The Director of Financial Resources will monitor long-term investment rates and identify any investment opportunities if market conditions change. This will enable the Council to invest balances available from sources such as the Strategic Investment Reserve, Schools, the Insurance Reserve and balances from any slippage of the capital programme.

13.6 The type of investments to be used by the in-house team will be limited to term deposits and interest bearing accounts and will follow the criteria as set out in Appendix H.

13.7 The Director of Financial Resources, in conjunction with the Council's treasury adviser Sector Treasury Services, and taking into account the minimum amount to be maintained in short-term investments will continue to monitor investment rates closely and to identify any appropriate investment opportunities that may arise.

13.8 The Council will also agree strict investment limits and investment criteria with any external fund managers it may appoint. These external fund managers will work to the following parameters:

- The institutions on the Approved Lending list of the external manager must correspond to those agreed with Sunderland City Council (i.e. only institutions on Sunderland City Council's Approved Lending List to be included as shown in Appendix I);
- they will be allowed to invest in term deposits, Certificates of Deposit (CD's) and government gilt securities;
- An investment limit of £3 million per institution (per manager);
- A maximum limit of 50% fund exposure to government gilts;
- A maximum proportion of the fund invested in instruments carrying rates of interest for periods longer than 364 days shall not exceed 50%. Again, it is proposed to only recommend the use of fixed term deposits up to a maximum of 2 years.

13.9 The details regarding the types of investment and the time periods to be permitted for investments are detailed in the Council's Approved Lending List (Appendix I) and also with reference to the Lending List Criteria set out in (Appendix H).

13.10 It is further proposed that:

- Delegated authority continue to be given to the Director of Financial Resources, in consultation with the Cabinet Portfolio holder for Resources, to vary the Lending List Criteria and Lending List itself should circumstances dictate, on the basis that changes be reported to Cabinet retrospectively, in accordance with normal Treasury Management reporting procedures.

14. End of Year Report

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