LEEDS CITY COUNCIL

Agenda Item:	
Originator:	M Hasnip
Tel:	x

Report of the Director of Corporate Services

Executive Board

Date: 17th February 2006

Subject: Treasury Management Policy and Strategy Statements

Electoral Wards Affected:

Specific Implications For:

Ethnic minorities ☐

Women ☐

Disabled people ☐

Narrowing the Gap ☐

Eligible for Call In: Yes

(Except for Recommendations 7.2, 7.3 and 7.4)

Not Eligible for Call In ☐
(Details contained in the report)

Executive Summary

This report sets out for Members approval the Treasury Management Strategy for 2006/07, and also provides an update on the implementation of the 2005/06 strategy.

The Council's level of net external debt is anticipated to be £1,098m by March 2006, slightly higher than was anticipated in November 2005 but in line with the approved strategy for 2005/06. Budgeted revenue savings of £1m from treasury management activity during the year have been achieved, and in addition a further £207k saving is anticipated.

Long term interest rates are currently at a low rate, and experts predict that they will rise steadily over the next two to three years. Some borrowing in advance of the 2006/07 borrowing requirement has already been undertaken, in order to lock in long term borrowing at the low rates currently available. Members are asked to recommend to Council an increase in the 2005/06 Authorised Limit on borrowing which is sufficient to allow the option to fund in advance up to the full borrowing requirement for 2006/07 and 2007/08, if economic forecasts indicate this to be prudent. Such advanced borrowing would only be carried out following a full risk evaluation, and in accordance with the advice of the council's treasury consultants.

1 Introduction

1.1. The operation of the Treasury Management function is governed by provisions set out under part 1 of the Local Government Act 2003 whereby the Council is required to have regard to the Chartered Institute of Public Finance and Accountancy (CIPFA) Prudential Code for Capital Finance in Local Authorities.

1.2. The Prudential Code requires that full Council set certain limits on the level and type of borrowing before the start of the financial year together with a number of Prudential indicators. Any in year revision of these limits must similarly be set by Council. In order to comply with this legal requirement recommendations 7.2, 7.3 and 7.4 of this report are not eligible for call-in.

1.3. The Code of Practice requires that policy statements are prepared for approval by the Council at least twice a year. The Policy and Strategy Statement for 2005/2006 was approved by the Executive Board on 14th February 2005 and by full Council on 23rd February 2005. The 2004/05 Treasury Management Annual Report was considered by Executive Board on 6th July 2005, and a review of the 2005/06 strategy was considered by Executive Board on 16th November 2005.

1.4. This report sets out for approval by Members the Treasury Management Strategy for 2006/2007 and the revised affordable borrowing limits under the prudential framework. It also provides Members with a review of strategy and operations in 2005/06.

2 Review of Strategy and Borrowing Limits 2005/2006

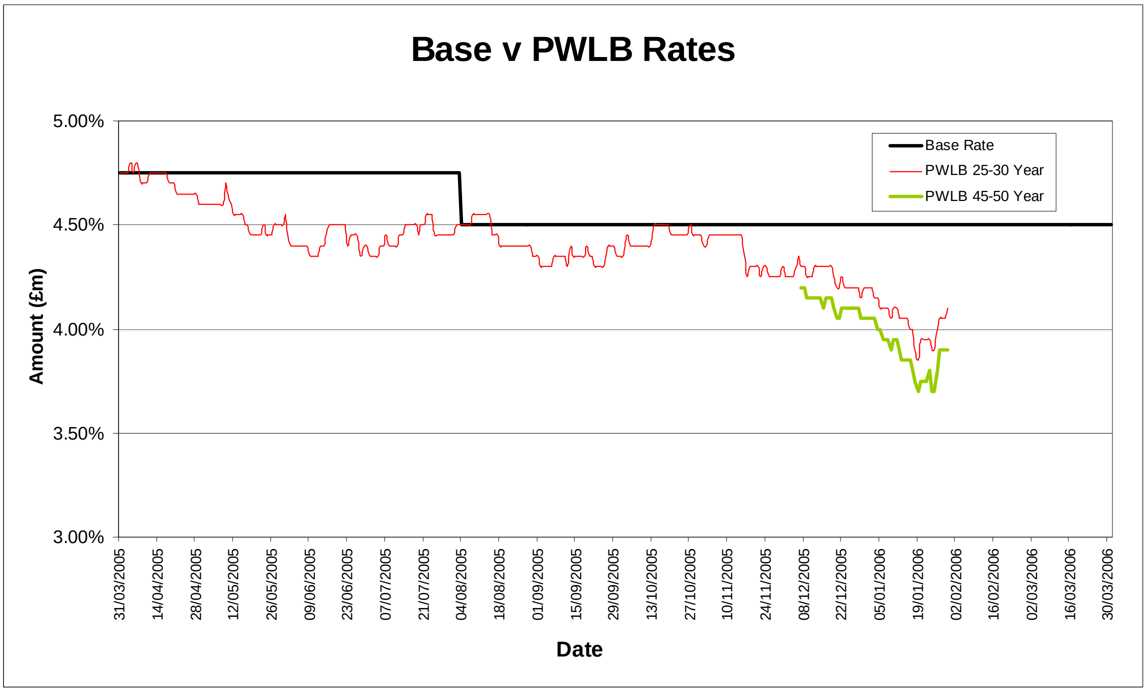
2.1 The current debt forecasts are given in Table 1 below, which shows that net external borrowing is now expected to stand at £1,098m by the end of 2005/2006, in line with expectations in February 2005, but above the forecast at November 2005.

Table 1

ANALYSIS OF BORROWING 2005/06		2005/06 Feb 05 £m	2005/06 Nov 05 £m	2005/06 This Report £m
Net Borrowing at 1 April		919	927	**927**
New Borrowing for the Capital Programme - HRA		120	115	**115**
New Borrowing for the Capital Programme – Non HRA		66	58	**80**
Debt redemption costs charged to Revenue (Incl HRA)		(25)	(24)	**(19)**
Reduced/(Increased) level of Revenue Balances		11	(5)	**(5)**
Net Borrowing at 31 March		1,091	1,071	**1,098**
* Comprised as follows				
Long term borrowing	Fixed	791	891	**971**
	Variable	130	95	**95**
Short term Borrowing		170	85	**56**
Total External Borrowing		1,091	1,071	**1,122**
Less Investments		-	-	**(24)**
Net External Borrowing		1,091	1,071	**1,098**
% borrowing funded by short term and variable rate loans		28%	17%	**13%**
2005/06 Capital Financing Requirement (Maximum Net Debt)		1,102	1,089	**1,131**
Less : Projected Finance Leasing		-	15	**21**
2005/06 Capital Financing Requirement – Borrowing Element		1,102	1,074	**1,110**

Note: The Capital Financing Requirement (CFR) is the maximum level of debt (i.e. borrowing and finance leasing) that the Council can hold for its current year capital purposes. The Council is also allowed to borrow in advance for up to two future years capital programmes.

2.2 Interest rate movements during the year are shown on the graph below. The Base Rate has moved in line with expectations at February 2005, staying at 4.75% until August 2005, when it reduced to its current level of 4.5%. This reduction reflected subdued output growth in the first half year and slowing of household spending and business investment growth. Inflation is currently in line with the Bank of England target. Economists predict that the Base Rate will fall to 4.25% in spring 2006, possibly going as low as 4.00%, but that it will rise again by early in 2007. Long term rates have fallen during the year and in the year to date PWLB rates for the 25 to 30 year period have ranged between 3.85% and 4.80%. In December 2005 the PWLB also introduced four new bands for loans of between 30 years and 50 years. Rates for the 40 to 50 year period have briefly dropped as low as 3.70%. These low levels are due to falls in gilt yields arising from a shortage of supply, caused by pension funds purchasing long dated gilts to match their liabilities. It is predicted that PWLB rates will remain at relatively low levels in the short term, until there is a further issue of long dated gilts. Economists then predict that long term rates are likely to rise in 2006/07 and 2007/08, with the 50 year PWLB rate expected to reach 4.25% by the end of 2006/07 and 4.5% to 4.75% in 2007/08.



2.3 To meet the borrowing requirement for the year, new loans of £201m have been taken, £156m from the Public Works Loans Board (PWLB) and £45m in market loans. This included £30m replacement funding for a maturing PWLB loan. Details of the individual loans taken out during the year are set out in Table 2. As in previous years, the market loans taken out are Lenders Option Borrowers Option (LOBO) instruments, and contain clauses which allow the lender, at pre-determined dates, to vary the interest rate on the loan. If one of these options is exercised and the new rate is not accepted, the borrower then has the option to repay the loan without penalty. In evaluating the authority's volatility and exposure to interest rate risk, LOBOs are treated as being variable in any year in which an option occurs.

2.4 In addition to funding the 2005/06 borrowing requirement, the historically low PWLB interest rates in the 40-50 year band presented an opportunity to borrow in advance for part of the 2006/07 borrowing requirement, investing the amounts until they are required. The opportunity was therefore taken to borrow £24m, in order to fund Stock maturing on 1st October 2006. These funds were borrowed at 3.70% and have been invested until the required date at 4.51%.

2.5 With long term rates at such low levels there has been limited opportunity to restructure PWLB loans to generate significant revenue savings. However, three loans totalling £12.3m have been rescheduled, generating a net discount of £16k and future annual revenue savings of £30k.

2.6 Rescheduling activity of LOBOs has continued with the objective of reducing volatility in the authority's loan portfolio. A total of £130m of LOBOs with original option dates every six months have been restructured during the year, to new structures with option dates of every 3, 5 or 6 years. This exercise has significantly reduced annual volatility, and as an additional benefit has also generated annual interest savings of £312k from

2006/07 onwards. A model has now been put in place to ensure that option dates in the authority's LOBO portfolio are evenly spread over future years, thus minimising the interest rate risk in any one year. The reduction achieved in the council's level of interest rate risk from its LOBO portfolio is illustrated by the graphs in Appendix C, which compare the annual volatility level of LOBOs at the start of 2005/06 and at the present date.

2.7 The revenue budget set in February 2005 assumed that savings of £1.0m would be delivered through rescheduling and improved balances. With new long term borrowing being taken at rates lower than anticipated and the part-year impact of LOBO rescheduling savings, this has been improved upon. To date a further £207k of savings have been achieved in General Fund. In the current interest rate climate it is not anticipated that there will be opportunities for further restructuring of loans to generate additional revenue savings.

Table 2

New Borrowing				
Date	**Source**	**Amount (£m)**	**Term (Years)**	**Interest Rate**
13/04/05	Market Loan	5.0	50	4.00%
06/05/05	PWLB	20.0	20	4.60%
11/05/05	Market Loan	10.0	50	3.99%
23/05/05	PWLB	30.0	30	4.45%
25/05/05	Market Loan	5.0	50	3.995%
25/05/05	Market Loan	5.0	50	3.995%
13/06/05	PWLB	30.0	50	4.35%
29/06/05	Market Loan	5.0	60	3.67%
29/06/05	Market Loan	5.0	60	3.67%
23/08/05	PWLB	30.0	8	4.35%
21/11/05	PWLB	25.0	27	4.25%
05/01/06	Market Loan	10.0	60	3.48%
23/01/06	PWLB	10.0	43	3.70%
23/01/06	PWLB	11.0	43	3.70%
Total New Borrowing for 2005/06 Requirements		**201.0**		
23/01/06	PWLB	10.0	47	3.70%
23/01/06	PWLB	14.0	45	3.70%
Total New Borrowing		**225.0**		

2.8 In February 2005, the Council set the operational boundary and authorised limit for its external debt for 2005/06 and the following two financial years. Both of these boundaries are made up of two elements, covering borrowing and other long term liabilities. Under the Prudential Code, the Director of Corporate Services has authority to make adjustments between the two elements, providing that the overall limits remain unchanged. In November 2005 it was reported to Executive Board that following a review of finance leasing activity, the Director of Corporate Services had increased the other long term liabilities limit from £10m to £20m and reduced the borrowing limit correspondingly. Current performance against borrowing limits is shown in Appendix B.

2.9 The decision to borrow some funds in advance for 2006/07 and continuing finance leasing activity make it appropriate to ask Members to increase both the borrowing and the other long term liabilities elements of the limits for 2005/06. In view of current interest rate forecasts which suggest that long term rates will continue to rise over the next two to three years, Members are asked to approve an increase in the authorised limit sufficient to allow the flexibility to borrow in advance up to the level of the predicted borrowing requirements for 2006/07 and 2007/08, if economic forecasts indicate that this would be prudent. Such advanced borrowing is permitted within the prudential code, and would only be carried out on the basis of a full risk evaluation and subject to the opinion of the council's treasury advisers.

Recommended : **Revised Operational Boundary and Authorised Limit for 2005/06 as below :**

	2005/06 Feb 05 £m	2005/06 Nov 05 £m	**2005/06 This Report Recommendation £m**
Authorised Limits			
Borrowing	1,185	1,175	**1,320**
Other Long Term Liabilities	10	20	**30**
Total	1,195	1,195	**1,350**
Operational Boundary			
Borrowing	1,100	1,090	**1,145**
Other Long Term Liabilities	10	20	**25**
Total	1,110	1,110	**1,170**

3 Strategy for 2006/2007

Table 3

ANALYSIS OF BORROWING 2005/06 – 2008/09		**2005/06 £m**	**2006/07 £m**	**2007/08 £m**	**2008/09 £m**
Net Borrowing at 1 April		927	1,098	1,239	1,340
New Borrowing for the Capital Programme - HRA		115	99	80	27
New Borrowing for the Capital Programme – Non HRA		80	67	50	51
Debt redemption costs charged to Revenue (Incl HRA)		(19)	(22)	(23)	(24)
Reduced/(Increased) level of Revenue Balances		(5)	(3)	(3)	(3)
Net Borrowing at 31 March		1,098	1,239	1,343	1,394
* Comprised as follows					
Long term borrowing	Existing Fixed	816	997	1,112	1,197
	Existing Variable	25	45	95	110
	New Borrowing	225	165	100	55
Short term Borrowing		56	32	36	32
Total External Borrowing		1,122	1,239	1,343	1,394
Less Investments		(24)	-	-	-
Net External Borrowing		1,098	1,239	1,343	1,394
% gross borrowing exposed to interest rate risk		27%	20%	17%	14%

Note: Borrowing exposed to interest rate risk in any one year is made up of short term borrowing, new long term borrowing and existing variable loans (i.e. LOBOs with an option falling within the year).

3.1 The table above shows that net external borrowing is expected to rise by £141m during the course of 2006/07. This represents the total borrowing requirement for the year, as the only maturing debt is the £24m Stock, for which replacement funding has already been taken and invested until the required date. As in recent years, borrowing to fund the HRA capital programme is anticipated to be higher than that required to fund the General Fund capital programme.

3.2 Currently, long term interest rates are below the Base Rate (4.50%). Economic forecasts are that the Base Rate will fall during 2006/07, possibly reaching a low of 4.00% before rising again to reach 4.25% by the end of 2006/07 and continuing to rise to 4.75% in 2007/08. Long term interest rates (PWLB 50 year rates) are expected to remain at or below 4.0% until summer 2006, when they are expected to rise to 4.25% by the end of 2006/07 and to 4.50% to 4.75% by the end of 2007/08.

3.3 In the case of market loans, it is possible to enter into agreements to borrow at a specific future date based on current interest rates. Since long term interest rates are currently low but are expected to rise during 2006/07, it was considered prudent, and in accordance with the opinion of the Council's treasury advisers, that this should be done for part of the 2006/07 borrowing requirement. Of the total £141m requirement for the year, agreements have therefore been entered into to borrow £35m of LOBOs in April, at rates of between 3.38% and 3.58%.

3.4 For the remaining funding requirement of £106m, the Director of Corporate Services will continue to monitor interest rates and market forecasts in order to inform borrowing decisions. Since long term interest rates are expected to rise, the possibility of further pre-funding of the 2006/07 borrowing requirement will be actively monitored.

3.5 It is anticipated that in the current interest rate climate there will be limited opportunity for making interest savings by rescheduling existing debt, however the position will be kept under review.

4 <u>Borrowing Limits for 2006/2007 , 2007/08 and 2008/09</u>

4.1 The Council is required to set its limits for external debt for 2006/07, 2007/08 and 2008/09 in accordance with the Local Government Act 2003, having regard for CIPFA's prudential code. These limits and other prudential indicators are detailed in Appendix A.

The authorised limit represents the legislative limit on the Council's external debt under the Local Government Act 2003. It should be set with sufficient headroom above the operational boundary to allow flexibility for planned borrowing to be undertaken, in order for prudent treasury management decisions to be taken and temporary cashflow fluctuations to be managed. It is recommended that Council approves the following authorised limits for its gross external debt for the next three years. Council is also asked to delegate authority to the Director of Corporate Services to make adjustments between the two separate limits provided that the overall limit remains unchanged. Any such adjustments will be reported to the next available Council meeting following the change.

Recommended : Authorised Limits as follows :

Authorised Limit	**2006/07 £m**	**2007/08 £m**	**2008/09 £m**
Borrowing	1,410	1,490	1,570
Other Long Term Liabilities	40	40	40
Total	**1,450**	**1,530**	**1,610**

4.2 The operational boundary should reflect the maximum anticipated level of external debt consistence with budgets and cashflow forecasts. It should be seen as a management tool for ongoing monitoring of external debt, and may be breached temporarily due to unusual cashflow movements. However, a sustained or regular trend above the operational boundary should trigger a review of both it and the authorised limit. The Council is asked to approve the operational boundaries set out below, and to delegate authority to the Director of Corporate Services to make adjustments between the two separate boundaries provided that the overall boundary remains unchanged. Any such adjustments will be reported to the next available Council meeting following the change.

Recommended : Operational Boundaries as follows :

Operational Boundary	**2006/07 £m**	**2007/08 £m**	**2008/09 £m**
Borrowing	1,260	1,365	1,415
Other Long Term Liabilities	30	30	30
Total	**1,290**	**1,395**	**1,445**

5 <u>Treasury Management Indicators</u>

5.1 The first prudential indicator in respect of treasury management is that the Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Services. This was adopted by the Council at the Executive Board meeting on the 13th March 2003.

5.2 The Council is required to set an upper limit on its fixed interest rate exposures for 2006/07, 2007/08 and 2008/09. This limit represents the maximum proportion of its net borrowing (i.e. measured as a percentage of its total borrowing less investments) which the Council will have at any given time during the period at fixed interest rates. The purpose of the limit is to ensure that the Council has the flexibility to take advantage of falling interest rates by ensuring a minimum level of variable rate debt. However setting a limit less than 100% can restrict the Council's ability to borrow in advance of need when long term fixed interest rates are at their low point. (This is the case since in general amounts borrowed in advance are invested, meaning that the net borrowing figure on which the limit is based will be lower than the total borrowing outstanding.) Therefore to provide the Council with maximum flexibility it is recommended that a limit of 115% be set for each year.

Recommended: Upper limit on fixed interest rate exposures for 2006/07, 2007/08 and 2008/09 of 115%

5.3 The Council is required to set an upper limit on its variable interest rate exposures for 2006/07, 2007/08 and 2008/09. This limit represents the maximum proportion of debt the Council will have at any given time during the period at variable interest rates and exposed to interest rate rises. In evaluating this figure, LOBOs are treated as being variable in years in which options occur and fixed in other years. The limit should be set in order to maintain a balance between managing the risk of rates rises and allowing sufficient flexibility to take advantage of any falls in rates. It is therefore recommended that a limit of 40% of debt be set for each year.

Recommended: **Upper limit on variable interest rate exposures for 2006/07, 2007/08 and 2008/09 of 40%**

5.4 The Council is required to set upper and lower limits for the maturity structure of its borrowings. This is designed to limit the risk of exposure to high interest rates by restricting the level of maturing debt in any given year. The limits represent the amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate and are proposed as follows:

	Upper limit	Lower limit
Under 12 months	30%	0%
12 months and within 24 months	30%	0%
24 months and within 5 years	40%	0%
5 years and within 10 years	50%	0%
10 years and above	90%	25%

Recommended: **Upper and Lower limits on fixed rate maturity structure as above.**

6 Investment Strategy and Limits

6.1 The Council's external debt is reduced by the availability of revenue balances. The Treasury Policy allows for the external investment of these balances should this prove cost effective. This could be undertaken by the Council or by External Fund managers on the Council's behalf. Throughout 2005/2006, the Director of Corporate Services has kept the interest outlook under review but has concluded that the market position is such that the external investment of revenue balances would not be beneficial. Investment of surplus balances is therefore in general limited to cashflow and liquidity management. The exception to this has been the investment of amounts borrowed to pre fund the stock maturity in October 2006 (see 2.6 above).

6.2 With effect from the 1st April 2004, to coincide with the introduction of the Prudential code, ODPM issued legislation and guidance on Local Government Investments. This legislation allows Councils with external debt to hold investments for more than 364 days, a freedom not previously allowed. Further freedoms were also introduced which give Councils greater flexibility and hence access to higher returns, provided that any investment strategy is consistent with the Prudential framework. The Prudential code requires that Councils set limits on investments for periods longer than 364 days. In the past this limit has been set at £10m, however in view of the new strategy to consider borrowing in the current year for part of the 2007/08 requirement, this limit now needs to be set at a level to allow any such advanced funding to be invested until it is required. It is therefore proposed:

Recommended: Upper limit on sums invested for periods longer than 364 days:

Total principal sum invested for a period longer than 364 days	**2005/06 £m**	**2006/07 £m**	**2007/08 £m**	**2008/09 £m**
Upper limit	100	100	100	100

6.3 Within these overall limits, the Council's treasury policy restricts the amount which can be invested at any one time with individual borrowers, in order to minimise the exposure to risk. The Council's treasury consultants provide regularly updated lists of credit ratings for potential borrowers, drawn from an international credit rating agency. The agreed treasury policy is to lend up to £15m to institutions with an excellent credit rating (typically UK clearing banks or other large financial institutions), and up to £5m for up to 3 months to institutions with good credit ratings.

7 Recommendations

That the Executive Board :

7.1 Approve the initial treasury strategy for 2006/07 as set out in Section 3 and note the review of the 2005/06 strategy and operations set out in Section 2.

7.2 Recommend to Council the setting of borrowing limits for 2006/07, 2007/08 and 2008/09 as set out in Section 4, and the revision of the 2005/06 borrowing limits as set out in paragraph 2.9.

7.3 Recommend to Council the setting of treasury management limits for 2006/07, 2007/08 and 2008/09 as set out in Section 5.

7.4 Recommend to Council the setting of investment limits for 2006/07, 2007/08 and 2008/09 as set out in Section 6.