

REPORT TO: FINANCE COMMITTEE – 10 MARCH 2003

REPORT ON: TREASURY MANAGEMENT STRATEGY 2003/2004

REPORT BY: DIRECTOR OF FINANCE

REPORT NO: 191-2003

1 PURPOSE OF REPORT

This report introduces the Dundee City Council Treasury Management Strategy for 2003/2004, the preparation of which is a requirement of the Council's Treasury Policy Statement.

2 RECOMMENDATION

The Committee are asked to:

- 1 note that in terms of the Treasury Policy Statement, the Director of Finance is obliged to present the annual Treasury Management Strategy at the start of each financial year.
- 2 approve the strategy proposed by the Director of Finance for 2003/2004 as set out in the attached document "Treasury Management Strategy 2003/2004".

3 FINANCIAL IMPLICATIONS

There are no direct financial implications arising from the recommendations in this report. However, decisions made within the Treasury Management function will affect the cost of the Council's long and short-term borrowing in 2003/2004 and future years. The 2003/04 Revenue Budget has been set including a provision of £20.425m for Capital Financing Costs and this is based on an average Loans Fund Interest rate of 6.35%.

4 LOCAL AGENDA 21 IMPLICATIONS

None.

5 EQUAL OPPORTUNITIES IMPLICATIONS

None.

6 BACKGROUND

The Council's Treasury Policy Statement approved on 11 March 2002 requires that the Finance Committee will receive and consider the Treasury Management Strategy in advance of each new financial year.

7 TREASURY MANAGEMENT STRATEGY 2003/2004

The Council's Treasury Management Strategy for 2003/2004 is set out in detail in the attached document. In summary, long-term borrowing rates are higher than short-term rates and this is expected to continue throughout 2003/2004. Short-term rates are expected to stay the same or fall slightly during 2003/2004. Interest savings will be maximised by utilising long-term borrowing facilities, where appropriate, to take advantage of low long-term interest rates and using short-term borrowing, where appropriate, to take advantage of any differential from long-term rates.

DAVID K DORWARD
DIRECTOR OF FINANCE

17 FEBRUARY 2003

BACKGROUND PAPERS

No background papers, as defined by Section 50D of the Local Government (Scotland) Act 1973 (other than any containing confidential or exempt information) were relied on to any material extent in preparing the above Report.

DUNDEE CITY COUNCIL

TREASURY MANAGEMENT STRATEGY 2003/2004

**Finance Department
Dundee**

TREASURY MANAGEMENT STRATEGY 2003/2004

1 INTRODUCTION

This Treasury Management Strategy details the expected activities of the Treasury Management function in the financial year 2003/2004. Its production and submission to the Finance Committee is a requirement of the Council's approved Treasury Policy Statement. Its format and structure is in the format required by the approved Policy. The suggested strategy for 2003/2004 in respect of the following aspects of the treasury management function is based upon the officers views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisers. The strategy covers:

- The current treasury position;
- Treasury limits in force which will limit the treasury risk and activities of the Council;
- Prospects for interest rates;
- Capital borrowings required and the portfolio strategy;
- Temporary Lending strategy;
- Debt rescheduling.

CURRENT TREASURY PORTFOLIO POSITION

The Council's loan debt position at 31 January 2003 was as follows:

| | | <u>£m</u> | <u>£m</u> | <u>%</u> |
|-----------------------|-------------------------|------------|--------------|--------------|
| Fixed Rate Funding | Public Works Loan Board | 246.3 | | |
| | Market Loans | <u>6.6</u> | 252.9 | 94.2 |
| Variable Rate Funding | Public Works Loan Board | 2.0 | | |
| | Market Loans | 12.7 | | |
| | Temporary Loans | <u>0.8</u> | <u>15.5</u> | <u>5.8</u> |
| Total Loan Debt | | | <u>268.4</u> | <u>100.0</u> |

TREASURY LIMITS FOR 2003/2004

In accordance with Section 45 of the Local Government and Housing Act 1989, which whilst not applicable to Scotland is recommended good practice, the Treasury limits set by Council as part of its Treasury Management policy are:-

- the amount of the overall borrowing limit which may be outstanding by way of short term borrowing:
 - initial term under 3 months (15% of total debt) Circa £40m
 - initial term under one year (20% of total debt) Circa £54m
- the maximum proportion of interest on borrowing which is subject to variable rate interest. (30% of total debt) Circa £81m

PROSPECTS FOR INTEREST RATES

The Council appointed Sector Treasury Services, formerly Prebon Financial Consultants, as treasury advisers to the Council on 9 August 1999 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 or variable and longer fixed interest rates for 2003/2004.

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

Shorter term interest rates – The US Federal Reserve Bank cut its central rate by 0.5% to 1.25% in November 2002 to counter prolonged weak economic growth, and falling share values (which undermine consumer confidence and thereby consumer expenditure). In the UK, base rate was unexpectedly cut by 0.25% to 3.75% in February as the focus of MPC concern shifted to overall prospects of a weakening UK economy from particular concerns for excessive house price increases and increases in consumer borrowing. While the central forecast is for base rate to remain unchanged for the rest of 2003, there are temporary risks to the downside for some months if growth prospects weaken further, before climbing back to 3.75% around the end of the year.

Longer term interest rates – PWLB rates fell considerably during 2002 as a result of safe haven flows of investment money where investors sell equities, and buy government bonds (gilts), so causing fixed interest rates to fall. This has consequently depressed PWLB rates below normally expected levels. In addition, the outlook for share values is not promising as corporate profit growth is expected to be weak, reflecting the overall weak rate of world growth. Consequently, a major reversal of the flight from shares into bonds in 2002 is not forecast for 2003. Gilt yields are therefore expected to remain at below normal levels in 2003 in sympathy with low international government bond yields in the worldwide low growth environment.

CAPITAL BORROWINGS REQUIRED AND THE PORTFOLIO STRATEGY

Based upon the prospects for interest rates outlined above, there are a number of strategy options available. The anticipation is that short-term rates will continue to be cheaper than long fixed rate borrowing for most of 2003/04. Short term rates are expected to be relatively stable at or near current levels. Long term rates are not currently expected to move far but if there is a major rally in share prices, then long rates would be susceptible to a corresponding rise. These expectations provide a variety of options:

- that short term rates will be good value compared to long term rates, and are expected to be relatively stable for a reasonable period, so that best value will be found by borrowing short term at variable rates, or for short fixed periods, in order to minimise borrowing costs in the short term or to make short term savings required in order to meet budgetary constraints.
- that the risks intrinsic in the shorter term variable rates are such, when compared to relatively low long term funding, which may be achievable in 2003/04, that the Council will maintain a stable, longer term portfolio by drawing longer term fixed rate funding at a marginally higher rate.

Against this background caution will be adopted with the 2003/04 treasury operations. The Director of Finance will monitor the interest rate market and adopt a pragmatic approach to any changing circumstances.

Sensitivity of the forecast - The main sensitivities of the forecast are likely to be the two scenarios 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 view:

- *an unexpected sharp rise in long and short term rates*, perhaps arising from an increase in world economic activity. In this event the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are relatively cheap.
- *an unexpected sharp fall in long and short term rates*, due to e.g. growth rates remaining low or weakening. In this event long term borrowings will be postponed, and any rescheduling from fixed rate funding into variable or short rate funding will be exercised.

6 TEMPORARY LENDING STRATEGY

It is not the Council's policy to be in a lending position although there are occasions when due to timing of cashflows the Council is lending funds for short periods of time.

Where the Council finds itself lending funds it will maximise its return taking into account the availability of interest rates and its own cashflow requirement.

Short term lending will be restricted to only those institutions identified in the Council's Approved Counterparties list. (Shown at Appendix B) provided they have maintained their credit rating. This list updates that contained in the Council's Treasury Policy Statement.

7 DEBT RESCHEDULING

The current and forecasted structure of interest rates do not provide a favourable environment for debt restructuring. However the situation will be continually monitored in order to take advantage of any perceived anomalies in the yield curve.

SF/AK(FV)
08 April 2003
TREAS-INV/TMS.03.04

OUTLOOK FOR INTEREST RATES

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), who both provide economic forecasting for Sector. The final two represent summarised figures drawn from the population of all major City banks and academic institutions. The current data shows the rates at the time of issue, not necessarily current rates. The forecast within the strategy statement has been drawn from these diverse sources and officers own views.

Individual Banks Forecasts

UBS Warburg Economic interest rate forecast (for quarter ends) - February 2003

| (%) | Current | Q1 2003 | Q2 2003 | Q3 2003 | Q4 2003 |
|--------------|---------|---------|---------|---------|---------|
| Base Rate | 3.75% | 3.75% | 3.75% | 3.75% | 3.75% |
| 10 Year Gilt | 4.23% | 4.50% | 4.50% | 4.50% | 4.50% |
| 30 Year Gilt | 4.28% | 4.25% | 4.25% | 4.25% | 4.25% |

Capital Economics interest rate forecast - February 2003

| (%) | Current | Q1 2003 | Q2 2003 | Q3 2003 | Q4 2003 | Q1 2004 | Q1 2004 |
|--------------|---------|---------|---------|---------|---------|---------|---------|
| Base Rate | 3.75% | 3.75% | 3.50% | 3.50% | 3.50% | 3.50% | 3.50% |
| 10 Year Gilt | 4.23% | 4.60% | 4.50% | 4.40% | 4.20% | 4.20% | 4.20% |
| 20 Year Gilt | 4.28% | 4.60% | 4.50% | 4.50% | 4.40% | 4.40% | 4.40% |

HSBC interest rate forecast - December 2002

| (%) | Current | Q1 2003 | Q2 2003 | Q3 2003 | Q4 2003 |
|--------------|---------|---------|---------|---------|---------|
| Base Rate | 3.75% | 4.00% | 4.00% | 4.00% | 4.00% |
| 10 Year Gilt | 4.23% | 4.50% | 4.30% | 4.20% | 4.20% |
| 30 Year Gilt | 4.28% | 4.40% | 4.40% | 4.40% | 4.30% |

Summary Bank Forecasts

HM Treasury - summary of 35 independent forecasters views of base rate - as at January 2003 (2004-2006 are as at November 2002)

| (%) | 2003 Year End | 2004 Year End | 2004 Average | 2005 Average | 2006 Average |
|---------|------------------|------------------|-----------------|-----------------|-----------------|
| Average | 4.27% | 4.59% | 5.14% | 5.12% | 4.81% |
| Highest | 5.00% | 6.40% | 6.10% | 5.60% | 5.00% |
| Lowest | 3.01% | 3.00% | 4.60% | 4.90% | 4.50% |

APPROVED COUNTERPARTIES FOR LENDING TRANSACTIONS

| <u>Approved Lending Bodies</u> | <u>Short Term Credit Rating</u> | <u>Maximum Deposits £m</u> |
|---|--|---|
| <u>Banks</u> | | |
| Abbey National plc | F1+ | 10 |
| HBOS (formerly Bank of Scotland and Halifax) | F1+ | 10 |
| Barclays Bank plc | F1+ | 10 |
| * Clydesdale Bank plc (National Australia Bank) | F1+ | 10 |
| Lloyds TSB Bank plc | F1+ | 10 |
| HSBC Bank plc | F1+ | 10 |
| Royal Bank of Scotland plc (inc National Westminster) | F1+ | 10 |
| Alliance and Leicester plc | F1+ | 10 |
| Bradford & Bingley plc | F1 | 5 |
| Anglo Irish Bank Corporation | F1 | 5 |
| <u>Building Societies</u> | | |
| Nationwide Building Society | F1+ | 10 |
| Britannia Building Society | F1 | 5 |
| Coventry Building Society | F1 | 5 |
| Skipton Building Society | F1 | 5 |
| Principality Building Society | F1 | 5 |
| Yorkshire Building Society | F1 | 5 |
| <u>Other</u> | | |
| Scottish Local Authorities | N/A | 5 |
| English and Welsh Local Authorities | N/A | 5 |

* This bank is a wholly owned subsidiary of the bank in brackets and the rating quoted refers to the parent bank.

NB Credit ratings indicate the capacity for timely repayments as follows:

| | |
|-----|----------------------------|
| F1+ | strongest |
| F1 | strong |
| F2 | satisfactory |
| F3 | adequate |
| B | uncertain |
| C | highly uncertain |
| D | actual or imminent default |