AGENDA ITEM

FALKIRK COUNCIL

Subject :	**TREASURY MANAGEMENT – INTERIM REVIEW 2008/09**
Meeting :	**POLICY & RESOURCES COMMITTEE**
Date:	**18 November 2008**
Author :	**DIRECTOR OF FINANCE**

1. INTRODUCTION

The terms of the Council's Treasury Management Practices require that an interim report on the Treasury Management function be produced by 31 December each year.

2. ECONOMIC AND INTEREST RATE OUTLOOK

2.1 At the time the Annual Strategy Report was approved in April, it was reported that the global economy was set for a significant slowdown. The US sub-prime mortgage crisis and the resultant liquidity "crunch" in the global banking system had increased the likelihood of recession. In response, western central banks, led by the US Federal Reserve, injected significant levels of liquidity into markets and also in the US and UK interest rates were eased.

2.2 In the Strategy Report, it was noted that UK interest rates had reached a level of 5.25% and indeed in April 2008 were further reduced to 5%. At that time, it was recognised that while the outlook for the UK economy had deteriorated, the Bank of England Monetary Policy Committee indicated that monetary policy would err on the side of caution until signs were evident that inflation had peaked. In the intervening period, the outlook for economies has deteriorated sharply to the extent that central governments across the globe have implemented a series of rescue packages to support their own key financial institutions. As part of these measures, in early October, central banks implemented a 0.5% cut in interest rates as a co-ordinated response to the crisis. Given the Bank of England's view that the balance of risk has tilted towards recession at the expense of inflation which is forecast to fall in the coming months, the bank recently announced a dramatic 1½ % reduction in the rate to 3%.

2.3 The Strategy Report indicated that longer term interest rates might rise towards 5% reflecting the need for higher gilt yields to attract the level of investment necessary to accommodate what would be a significant rise in gilts issuance required by the Government to fund its support packages to ailing financial institutions. However, over the remainder of the financial year, it is anticipated that longer term rates may well trade in a range of around 4% for periods of up to five years and nearer 4.5% for longer periods, as they benefit from the anticipated decline in short term rates and the expected healthy demand for government securities as a safe haven for investors during the current market volatility.

3. BORROWING STRATEGY

3.1 The Council's longer term borrowing requirement has been revised to £11m, a marked increase of £7.4m in the level as advised in the Annual Strategy report to Committee in April. The revised forecast reflects a combination of a less than anticipated level of sales in housing stock and a reduction in General Fund capital receipts not being received in the current year. Both of these issues have been highlighted in the regular Capital Programme updates made to this Committee.

3.2 In the Strategy Report, it was noted that the Council's longer term borrowing requirement for the year would be relatively minor and as such it was planned to finance any funding linked to short term rates. The report also highlighted the potential for four Market Loans up to a value of £26m to be repaid during the year should any of the lenders invoke a rate change clause as per their contracts.

3.3 In the current year to date, fears of a global recession have increased and resulted in a complete re-assessment of the future direction of interest rates. In particular, short term rates are expected to decline sharply following the reduction in base rate to 3%. Despite the marked increase in longer term funding identified at para 3.1, it is proposed that such funding continues to be met on terms linked to short term rates. The potential for repayment of any of the Market Loans identified at para 3.2 remains low given the current structure of longer term rates.

3.4 Members will recall, in previous reports to this Committee, that a policy change by the Public Works Loans Board in November 2007 had effectively brought debt rescheduling activities to an abrupt halt and that it would require a significant upward shift in yields to re-activate this treasury tool. In fact, the extreme market volatility experienced this year created such a scenario to the extent that in mid-October, the undernoted debt rescheduling transaction was concluded.

- Repay 3 PWLB fixed rate loans totalling £24.3m with an average period to maturity of 43 years and an average rate of 4.52%.
- Redeemed loans repaid without penalty.

- Replacement funding secured through a reduction in Council's temporary deposits by a similar amount.

The main driver for the transaction was the opportunity to significantly reduce the level of deposits currently on loan with financial institutions in a climate where concerns have been raised over the security of certain counterparties.

4. INVESTMENT STRATEGY

4.1 The Council manages its short term surplus funds by investing from time to time with other Local Authorities and financial institutions subject to strict credit rating criteria consistent with the Council's Treasury Management Practices.

4.2 Previous reports to this Committee have highlighted the increased counterparty risk which has evolved as the financial crisis worsens and the various interim measures introduced by the Council in light of prevailing market events. Over time, a number of financial institutions have had their credit ratings downgraded and as such have been removed from the Council's approved list. Also, current monetary limits of either £5m or £3m to specific counterparties have been applied, together with a maximum period for lending of one month. The decision to repay the PWLB loans identified at para 3.4 will also have the effect of reducing the level of counter-party risk.

4.3 Members may wish to note the criteria used to determine the selection of Building Societies on the Council's approved counterparty list. This is designed to ensure prudent protection for public funds. The main criteria is based on a minimum level Fitch (or equivalent rating agencies) short term credit rating of "F1" and a long term credit rating of "A". Additionally for Building Societies, they must have total assets of greater than £5 billion. Taking both criteria together and given a number of other mergers in the sector, only a few societies currently qualify as approved counterparties, namely Nationwide, Yorkshire, Coventry & Chelsea. Building Societies in Scotland do not qualify under either of the criteria set by the Council.

4.4 As previously reported, the Council continues to invest a large part of its Pension Fund cash surpluses with the Fund's custodian, Northern Trust, in its AAA rated Sterling Cash Fund. Only a working balance of pension fund cash is retained and pooled with Council monies for treasury management purposes.

4.5 Draft Investment Regulations and a supporting Code, issued for consultation in May 2008, propose a more structured approach to accounting for, and reporting on, local authority investments. While the consultation period has ended, it can be assumed that the financial crisis will at the very least cause the Scottish Government to consider if any further controls/restrictions require to be introduced. An implementation date of April 2009 is planned for the new Investment Regulations.

5. PRUDENTIAL CODE

Consistent with the requirements of the Prudential Code, a series of Treasury Management indicators have been devised as part of the overall suite of Prudential Indicators which are used to demonstrate that Council capital spending plans are affordable, prudent and sustainable. Monitoring and review of these indicators are incorporated in the periodic Capital Programme updates made to this Committee.

6. CONCLUSION

The prospects for a sharp fall in short term rates, following the dramatic cut in base rate, will have a beneficial effect on the overall borrowing costs of the Council for the current financial year. Given the unprecedented events unfolding in financial markets, the Treasury Section and our advisers will continue to remain vigilant to any new developments and having particular regard to the Council's exposure to counterparty risk.

7. RECOMMENDATION

Members are asked to note the progress of the Council's Treasury Management Strategy for 2008/09.

Director of Finance

Date : 20 October 2008

LIST OF BACKGROUND PAPERS

1. Treasury Management Strategy 2008/09 submitted to Policy & Resources Committee on 8 April 2008.

Any person wishing to inspect the above background papers should telephone Falkirk (01324) 506338 and ask for Alastair Redpath.