CAB1890
FOR DECISION
WARD(S): GENERAL

CABINET

16 September 2009

PRINCIPAL SCRUTINY COMMITTEE

21 September 2009

TREASURY MANAGEMENT STEWARDSHIP REPORT FOR 2008/09

REPORT OF HEAD OF FINANCE

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RECENT REFERENCES:

CAB1599 : Treasury Management Strategy, 13 February 2008
CAB1712 : Treasury Management Stewardship, 17 September 2008
CAB1754 : Revised Investment Strategy, 18 November 2008
CAB1785 : Treasury Management Strategy, 4 February 2009

EXECUTIVE SUMMARY:

This report provides information on the stewardship of the Treasury Management function for the financial year 2008/09 and comments on treasury management activity during that financial year.

The Head of Finance confirms that no borrowing was undertaken in 2008/09.

Please see Appendix A for the Actual Prudential Indicators.

The financial year 2008/09 presented exceptional circumstances with regard to treasury management. The downturn in the economy, coupled with increased counterparty credit risk presented the Council with additional issues not normally encountered. The main implications of the exceptional circumstance have been:

- £1,000,000 invested with Heritable Bank which has gone into administration. This was due to mature on the 16 March 2009. We have had our first distribution of £161,817 from the administrator at the end of July 2009.

- Increase in counterparty risk which resulted in a restricted counter party policy as set out in CAB1754 in November 2008.

RECOMMENDATIONS:

To Cabinet:

That Cabinet approves the treasury management stewardship report for 2008/09 and the Actual 2008/09 Prudential Indicators at Appendix A.

To Principal Scrutiny Committee

That Principal Scrutiny Committee consider the treasury management stewardship report for 2008/09 and the Actual 2008/09 Prudential Indicators at Appendix A.

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TREASURY MANAGEMENT STEWARDSHIP REPORT FOR 2008/09

REPORT OF HEAD OF FINANCE

1 Introduction

1.1 The Council operates its treasury management service in compliance with the *Code of Practice for Treasury Management in the Public Services*, the *Prudential Code for Capital Finance in Local Government* (both published by CIPFA) , the *Guidance on Local Government Investments* and Minimum Revenue Provision Statement Statutory Guidance (both published by DCLG). The prime objective of the treasury management activity is the effective management and control of risk.

1.2 The Codes require the regular reporting of treasury management activities, forecasting likely activity for the forthcoming year (in the Annual Treasury Strategy Report – CAB1785) and reporting on actual activity for the preceding year (this report).

1.3 This report covers:

- The capital activity for 2008/09
- The strategy agreed for 2008/09
- Performance indicators for 2008/09
- A summary of the economic factors affecting the strategy during 2008/09
- The Council's treasury position at the year end
- Borrowing
- Investments
- The compliance of the treasury service with internal and external requirements
- Treasury Management Advisors

2 The Council's Capital Expenditure and Financing 2008/09

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

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.); or
- If insufficient financing is available, or a decision is taken not to apply resources, the expenditure will give rise to a borrowing need.

2.2 The Council has previously fully financed its capital expenditure and does not currently have a borrowing need.

2.3 The actual capital expenditure forms one of the required prudential indicators (Appendix A). The table below also shows how this was financed

£000's	2007/08 Actual	2008/09 Estimate	2008/09 Actual
General Fund	4,748	11,300	2,976
HRA capital expenditure	4,663	4,500	3,594
Total capital expenditure	**9,411**	**15,800**	**6,570**
Resourced by:			
Capital receipts	3,380	10,500	2,520
Capital grants	1,384	700	575
Capital reserves	3,315	4,600	3,094
Revenue	1,332	0	381
Total Resources Applied	**9,411**	**15,800**	**6,570**

2.4 The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This figure is a gauge for the Council's debt position. This Council currently has a net CFR of nil, and so has no underlying need to borrow for a capital purpose (see Appendix A).

3 <u>Treasury Management Strategy for 2008/09</u>

3.1 The Treasury Management Strategy for 2008/09 was approved by Council on 21 February 2008 (CAB1599 refers) but due to the exceptional instability in the world's financial markets which impacted on the Council's investments a revised investment strategy was approved by the Council on 7 January 2009 (CAB1754 refers).

3.2 It should be noted that the accounting practice required to be followed by the Council (the SoRP), changed from the 2007/08 accounts, and required financial instruments in the accounts (debt, investments, etc.) to be measured in a method compliant with national Financial Reporting Standards. The figures in this report are based on the principal amounts borrowed and invested and so may differ form those in the final accounts by items such as accrued interest.

4 Performance Indicators

4.1 The following treasury management indicators were set for 2008/09:

a) Debt – Borrowing - Average rate of borrowing for the year compared to average available.

b) Debt – Average rate movement year on year .

c) Investments – Internal returns above the 7 day LIBID rate.

d) Investments – External fund managers - returns 110% above 7 day compounded LIBID.

4.2 Performance against these indicators was as follows:-

a) Not applicable, no debt.

b) Not applicable, no debt.

c) Investments:

- 3.71% was the average 7 day LIBID rate
- 5.21% was the rate achieved excluding Heritable Bank
- 1.50% in excess of the performance indicator
- An additional £444,900 benefit to the Council based on average balance invested of £29,659,000.

d) Not applicable as no investment was managed by external fund managers.

5 Economic Background for 2008/09

5.1 The 2008/09 financial year has featured one of the most testing and difficult economic and investment environments since the 1930s. It has featured a number of very significant changes in the performance of the UK as well as global economy, and beneath all of this has been the undercurrent of uncertainty and mistrust in the financial markets. This was not an easy backdrop in which to manage an investment portfolio.

5.2 The year opened on an uncertain note. The ongoing effects of the “credit crunch” which had started in 2007 prompted a bout of monetary policy easing in early April when the Bank of England cut its Bank Rate by 0.25% to 5%.

5.3 But inflation was rising sharply, because of the strength of global commodity and food prices and the very steep rise in oil prices. The CPI inflation measure breached the 3% upper limit of the Governments’ target range in April. The Bank was concerned that these external cost pressures could eventually transform into a domestic wage/price spiral and kick start a bout of damaging inflation.

5.4 Rates were left on hold through the summer months and there seemed to be some signs of a gradual return to slightly more normal conditions in the money markets. But this was not to last; mid-September saw a “sea change” in financial markets and economic policies. The collapse of US investment bank, Lehman Brothers, dealt a devastating blow to the markets. Liquidity dried up almost completely making it extremely difficult for banks to function normally. These developments culminated in the failure of the entire Icelandic banking system in early October.

5.5 The failure of the Icelandic banking system had a major impact on local authority investments. A number of local authorities had deposits with Icelandic institutions. The Council has an investment of £1,000,000 with Heritable Bank, a UK registered bank, and wholly owned subsidiary of the Icelandic Bank - Landsbanki. Based on a common approach across all government (CIPFA LAAP82) an estimate of 20% irrecoverable has been charged as an impairment in the Financial Statements (see paragraph 3.2).

5.6 The first distribution from the administrator of £161,817 was received at the end of July 2009 representing 16.13p in the pound. On 13 August 2009, the administrators issued a formal update to creditors. The report stressed that the base case return of 70-80p in the pound outlined in the April update remains unchanged. It also stated that if conditions change over the next few years, the final recovery could be higher than the base case projections; conversely, in more adverse circumstances, they could be lower, with a ‘stressed-case’ return in the region of 55p-70p. It is expected that a second payment of 10p in the pound will be made before the end of 2009.

5.7 The crisis in the financial markets deepened and threatened a complete ‘melt-down’ of the world financial system. This, together with evidence that economies had entered recession prompted a number of significant policy changes. In the UK these featured the following:

a) a major rescue package totalling as much as £400bn to recapitalise the banking system

b) a series of interest rate cuts down to 2% in early December

c) a fiscal expansion package, including a 2.5% cut in VAT.

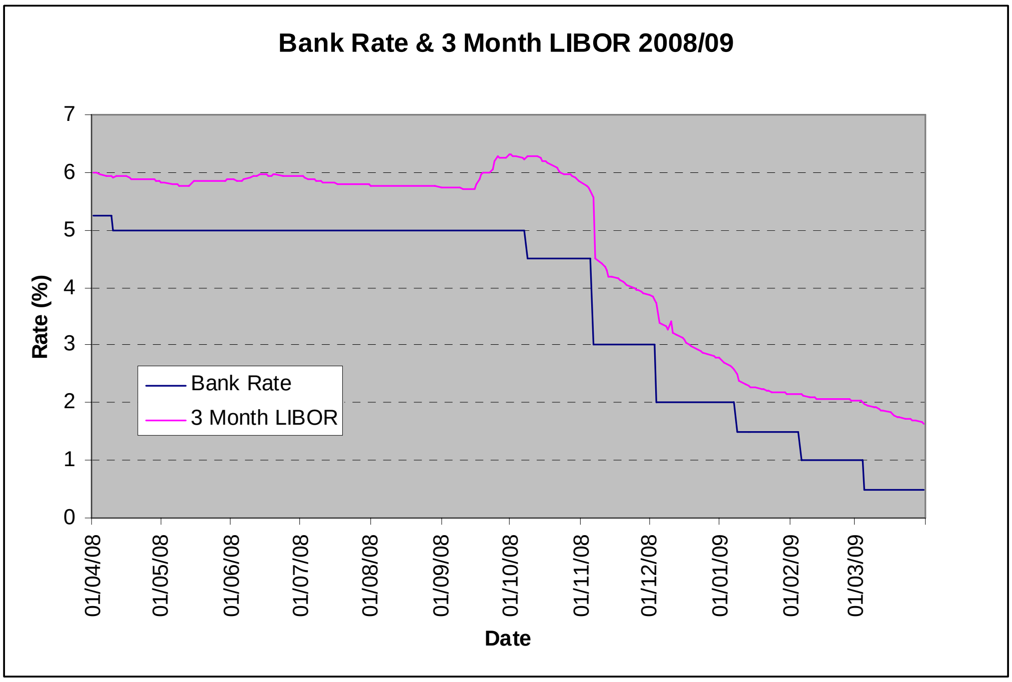
5.8 The New Year failed to herald a change in the fortunes of the banking sector. Central banks continued to ease monetary policies in an attempt to reduce borrowing rates and hence alleviate some of the cost pressures being experienced by financial institutions and, more to the point, the corporate and household sectors.

5.9 With official interest rates in the US already at close to zero at end-2008, the Bank of England was at the forefront of policy easing. Bank Rate was cut in successive monthly moves from 2% at the outset of the year to the historically low level of 0.5% in March 2009. Thereafter, the Bank resorted to the quantitative easing of monetary policy via a mechanism of buying securities from investment institutions in exchange for cash. This commenced in early March and is expected ultimately to amount to £150bn.

5.10 Aside from Bank of England assistance, the central Government launched the second phase of its support operations for the banking industry during the second half of January. This failed to allay fears that even more aid might have to be extended to the banking industry before the crisis is over. During the course of the quarter, two major banks, RBS and Lloyds Group, needed substantial cash injections; action that led the public sector to assume near-full ownership. In addition to this, the Dunfermline Building Society was rescued from bankruptcy.

5.11 The problems of the financial markets since late 2007 had clearly spread to other parts of the economy. Economic data confirmed that the UK was in deep recession and the latest Bank of England Inflation Report (published in mid-February) registered a marked change in official forecasts for 2009 and 2010. Economic activity was expected to decline sharply (GDP was forecast to contract by more than 4% in 2009) and inflation was projected to fall into negative territory.

5.12 The generally uncertain backdrop to the UK and the financial markets prevented a marked easing in overall money market liquidity. While the situation did show some signs of improving as the financial year drew to a close, the margin between official interest rates and those quoted in the inter-bank market for periods longer that 1-month remained very wide.



6 The Council's treasury position at the year end

Summary	31 March 2009		31 March 2008	
	Principal	Average Rate	Principal	Average Rate
Fixed Interest Rate Debt	0	0%	0	0%
Variable Interest Rate Debt	0	0%	0	0%
Total Debt	0	0%	0	0%
Short -term Fixed Interest Investments (excluding Heritable bank- see below)	£20.80m	3.03%	£23.00m	5.89%
Short-term Variable Rate Investments	0	0%	0	0%
Long-term Variable Interest Investments	£1.00m	6.40%	£1.00m	5.36%
Corporate Deposit Account	£1.00m	0.51%	£0.78m	5.55%
Total Investments (excl. Heritable)	£22.80m	3.07%	£24.78m	5.86%
Heritable Bank (in administration)	£1.00m	6.00%	0	0%

7 Borrowing

7.1 Following the decision of Council on 27 February 2002 all long-term debt was prematurely repaid.

7.2 In the period 1st April 2008 to 31st March 2009 no loans were taken out but for short term operational reasons the agreed bank overdraft facility was used on 23 days, for a maximum of 3 days in a row.

8 Short Term Investments

8.1 Investment policy - The Council's investment policy is governed by ODPM (now CLG) Guidance, which has been implemented by the annual investment strategy approved by Council on 21 February 2008 (CAB1599 refers). Due to the unprecedented instability in the financial markets a revised investment strategy was approved by Council on 7 January 2009 (CAB1754). The investment activity during the year conformed to the approved strategy.

8.2 The Council maintained an average balance of £29.7 million of internally managed funds achieving a return of 5.21%. The comparable performance indicator is the average 7-day LIBID rate, which was 3.71%.

8.3 The reason for achieving high rates is that before the financial meltdown the average investment period was 278 days so the Council's investments were locked into higher rates as the interest rate collapsed from October onwards. From October 2008 onwards the average investment period dropped to 22 days in line with the revised investment strategy. This also means that from April to September there were 18 investments made but October – March 104 investments have been made; a 5 fold increase in activity. The investments that were held at 31 March 2009 are shown in Appendix B.

9 Long Term Investments

9.1 The only long-term investment the Council holds is with the Local Authorities Mutual Investment Trust (LAMIT). A property investment of £1 million was made in March 1990, with the General Fund receiving the investment income.

9.2 As at 31 March 2009 the value of this investment had dropped to £0.821 million (£1.335 million at 31 March 2008). The impairment (falling below cost price) of £0.179 million was deferred in line with statutory instrument 2009/321 as it is expected to be a temporary situation caused by the current financial crisis. Dividends of £64,000 were received in 2008/09 (6.40%).

9.3 During 2008/09 the £50,000 long term debenture with the Association of District Councils (ADC) was repaid when the property was disposed of. This was non-interest bearing and the Council received a redemption premium of £9,242.

10 Regulatory Framework, Risk and Performance

10.1 The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance;

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;
- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken;
- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;
- Under the Act the ODPM (now DCLG) has issued Investment Guidance to structure and regulate the Council's investment activities;
- Under section 238(2) of the Local Government and Public Involvement in Health Act 2007 the Secretary of State has taken powers to issue guidance on accounting practices. Guidance on Minimum Revenue Provision was issued under this section on 8th November 2007.

10.2 The Council has complied with all of the above relevant statutory and regulatory requirements which limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

11 Treasury Management Advisors

11.1 During 2008/09 Butlers continued to act as the Council's treasury management advisors offering support and advice on treasury management activities, which was taken up on a number of occasions.

OTHER CONSIDERATIONS:

12 SUSTAINABLE COMMUNITY STRATEGY AND CORPORATE BUSINESS PLAN (RELEVANCE TO):

12.1 Treasury Management supports all tenets of the Sustainable Community Strategy as well as the core value of being efficient and offering value for money.

13 RESOURCE IMPLICATIONS:

13.1 Interest and investment income amounted to £1,929k in 2008/09.

14 RISK MANAGEMENT ISSUES

14.1 These are considered within the report.

BACKGROUND DOCUMENTS:

Operational and financial records held in the Financial Services Division.

APPENDICES:

Appendix A - Actual Prudential Indicators for 2008/09

Appendix B - Investments held at 31st March 2009

TREASURY MANAGEMENT STEWARDSHIP REPORT

Actual Prudential Indicators	**2007/08**	**2008/09**
Actual Capital Expenditure	£000's	£000's
General Fund	4,748	2,976
HRA	4,663	3,594
Total	9,411	6,570
Capital Financing Requirement:		
General Fund	(10,100)	(10,100)
HRA	10,100	10,100
Total	0	0
Financing Costs as a proportion of Net Revenue Stream	%	%
Council Tax	0	0
Housing Rents	3.4	2.3

Investments held at 31st March 2009

Borrower	Amount £	Repayment Date	Rate %
DMO	5,800,000	Latest 17/04/2009	Ave 0.34
National Counties Building Society	1,000,000	01/04/2009	5.96
Stroud & Swindon Building Society	1,000,000	07/04/2009	6.25
Plymouth City Council	1,000,000	16/04/2009	1.30
Barclays	1,000,000	24/04/2009	0.70
Skipton Building Society	1,000,000	14/05/2009	6.15
Cheshire Building Society	1,000,000	02/06/2009	6.20
Nottingham Building Society	1,000,000	02/06/2009	6.21
Cumberland Building Society	1,000,000	03/06/2009	6.28
Hartlepool Borough Council	1,000,000	19/06/2009	0.50
Abbey National Plc	1,000,000	22/06/2009	1.62
Leeds City Council	1,000,000	22/06/2009	0.45
Wirral MBC	1,000,000	24/06/2009	0.50
Close Brothers	1,000,000	07/07/2009	6.50
Leek United Building Society	1,000,000	04/08/2009	6.30
Newbury Building Society	1,000,000	15/09/2009	6.20
	20,800,000		

Bank of Scotland – call account	1,000,000	7 day call	0.51%

Long Term Investments held at 31st March 2009

Borrower	Amount £	Repayment Date	Rate %
Local Authorities Mutual Investment Trust			
Principal	1,000,000		
Deferred Impairment	(179,037)		
Net Book Value	820,963	Flexible	Variable

Heritable Bank in Administration			
Principal	1,000,000	16/03/2009	6.00
Impairment of Principal - 20%	(200,000)		
Recoverable (per LAAP82)	800,000		

Note £161,817 distribution received from administrator July 2009