Appendix A

Treasury Management Outturn Report 2008/09

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Introduction and Background

1. The Council's Treasury Management function is concerned with the management of the Council's debts, investments, cashflow and banking arrangements. These activities are regulated by a variety of professional codes and statutes and guidance. More specifically, treasury management in this context is defined as:-

   "The management of the local authority's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. "

2. It is a requirement of the Council's Treasury Management Policy that a report is presented to the Council's Executive providing details of the treasury management activities undertaken in the preceding financial year. This annual report provides Members with the following information for 2008/09:-

   i) Economic Commentary on the year
   ii) Investment Activity
   iii) Borrowing Activity
   iv) Compliance with Treasury Limits
   v) Banking Facilities
   vi) Treasury Advisors

3. In addition to the matters raised above, this report provides details of the Council's performance against a series of prudential indicators which were established following the introduction of the Prudential Code for Capital Finance in Local Authorities in 2004/05.

Economic Commentary for 2008/09

4. **Appendix A** sets out the economic background in which the Council's treasury management function has operated in during 2008/09. This is provided to give Members an overview of market conditions, particularly the movement in base rates and the longer terms PWLB rates, against which the Treasury function has performed during the year.

5. As explained at **Appendix A**, the financial year 2008/09 has seen some unprecedented activity in the global financial markets as a result of the impact of the 'credit crunch'. To a large extent, the Council has been protected from the worst effects of this due to debt being largely at fixed rates and employing a cautious investment strategy.

6. Going forward, however, lower interest rates and the continuing instability in the financial markets have both impacted on the Council's ability to lend funds and achieve a reasonable return. As ever, the focus of the investment strategy remains the protection of the Council's capital investment over the returns achieved. To this end, we have been pursuing a strategy of using internal borrowing to fund capital investment, both because of the limited returns on investment and a conscious decision to reduce the level of funds under investment. More details of this are included in the Treasury Strategy for 2009/10 and an update on that Strategy will be provided to the Executive in October 2009.

Borrowings

Long Term Borrowing

7. At the beginning of the current financial year, the Council had long-term loans of £7.859m, comprising wholly of Public Works Loan Board (PWLB) debts. During the year, there have been the following changes in the Council's debt portfolio:-

a) Additional PWLB loan debt of £2.0m was taken during October 2008. At the time of borrowing, the Council's underlying notional debt, as measured by the Capital Financing Requirement (CFR), was £8.304m, slightly in excess of external debt which was £7.859m. However, it was estimated that, as a result of the Council's estimated capital investment in 2008/09, the CFR could increase by a further £6m by the year end (or at least over the next 3 years).

   Without any further external borrowing, the increase in the CFR would have been met from internal borrowing potentially impacting on the investment returns being achieved by the Council at that time. As a consequence, additional borrowing of £2m was taken from the PWLB for one year at a rate of 3.16%. The amount of borrowing was limited to £2m to ensure that the Council did not breach its approved borrowing limit (the Operational Boundary for borrowing is currently £10m and the Authorised Limit is £12m) and was limited to one year in anticipation of further reductions in PWLB rates (which have since occurred); and

b) a restructuring of the existing debt portfolio which resulted in the repayment of 3 loans totalling £3m at an average cost of 4.58% (and an average duration of 26years) which were replaced by 2 loans totalling £3m at an average cost of 1.38% (with an average during of less than 2 years).

8. Underlying the actions taken above in relation to the Council's debt portfolio during 2008/09 is a strategy to take advantage of extremely low short term PWLB interest rates as a means of financing the Council's capital investment plans. Table 2 below provides an analysis of the maturity structure of the Council's debt portfolio:-

Table 2: Maturity Structure of the Debt Portfolio

		1st April 2008		Current Position	
	Upper Limit	Principal £m	Maturity Structure %	Principal £m	Maturity Structure %
Under 12 months	30%	-	0%	2,750	28%
12 months to 2 years	40%	1,000	13%	3,250	33%
2 years to 5 years	50%	2,000	25%	2,000	20%
5 years to 10 years	50%	-	0%	-	0%
10 years and above	75%	4,859	62%	1,859	19%
Total		7,859		9,859	

9. As table 2 indicates, at the beginning of the last financial year, the Council's debt was largely placed at the longer end of the PWLB debt structure, ie 10 years and above. However, in view of the lower interest rates at the shorter durations over the last few months, opportunities have been taken both to increase the amount of external debt in lieu of internal borrowing as well as reschedule some longer term debt to shorter durations. Overall, this has reduced the cost of external debt from an average of 4.36% to an average of 3.15%.

10. Overall, therefore, the balance of the Council's long term debt as at 31st March 2009 was £9.859m (although technically it should be noted that the debt comprises £7.109m long term debt and £2.750m of short term debt which is due for repayment within 2009/10). An analysis of the Council's long-term debt portfolio (and how it has changed since 1st April 2008) is provided at **Appendix B** whilst **Appendix C** provides an analysis of the maturity dates for this debt. It should be noted that the current average cost of this debt is 4.36%.

11. The General Fund revised budget for debt charges for 2008/09 was £695,430 comprising £401,590 for interest on outstanding debt, £280,000 for the minimum revenue provision and £13,840 for premia payable as a result of debt restructuring exercises in previous years. Actual debt charges for the year were (including MRP and premia) £618,778, a saving of £76,652 when compared to the budget.

Short Term Borrowing

12. Subject to daily cashflow, the Council borrows funds on a temporary basis to meet cashflow deficits; this is a normal part of the treasury management process. During 2007/08 it was necessary to borrow temporarily on 13 occasions (total borrowings of £14.5m) at an overall cost for the year of £4,393.

13. At the end of the financial year, the Council had temporary loans of £2.0m outstanding, all of which was repaid on 15th April 2009.

Investments Activity

14. The Council manages its in investments in-house. All investments were placed with institutions authorised in accordance with the Council's Treasury Management Practice Notes. Investments are made for a range of periods, dependent on the Council's cash flows, its interest rate view and the interest rates on offer.

15. The Council started the year with investments of £9.520m reducing to £13.500m by 31st March 2009. The level of investment activity is summarised in table 1 below:-

Table 1: Investment Activity 2008/09

	£000	No.
Opening Balance	9,520	7
New Investments	85,601	331
Investments Realised	(81,621)	331
Balance of Investments at 31st March 2009	**13,500**	**7**

16. As the table indicates, a total of 331 investments amounting to £85.601m were placed at various times during the year, details of which were reported to the Executive as part of the regular Corporate Monitoring reports. A summary of all investments placed and realised during the year is provided at **Appendix D** which also shows the interest rate of return with each Counterparty. A graph showing the balance of amounts under investment during the year is provided at **Appendix E**.

17. The Approved Budget for interest and investment income for 2008/09 on the General Fund was £800,000 whilst the actual level achieved was £868,974, some £68,974 more than budgeted. The reasons why the investment income for the year has exceeded budget include:-

a) higher than anticipated interest rates during the year;

b) surplus cash balances have been higher than anticipated primarily due to the underspend on the Council's Capital Programme; and

c) an opportunity has been taken to exploit the low cost of PWLB debt in place in internal borrowing (particularly given the extent to which the Council has been using internal borrowing to finance its capital programme).

18. As indicated, in its simplest terms, the actual return on investments is a function of the amount of surplus cash available for investment, the timing of investments and the interest rates at which any such funds are invested. As the Council's investments are restricted to cash deposits (to authorised counterparties), the interest returns achieved are generally linked to the bank base rate as determined by the Monetary Policy Committee (MPC) on a monthly basis although the recent turmoil in the financial markets has resulted in a greater level of volatility than has previously been the case. Nevertheless, the overall average return on investments for the year was 5.26% which is considered good when compared to both the average 7 day (uncompounded) LIBID return of 3.69% and the 3 month (uncompounded) LIBID return of 4.48%, both of which are the standard comparators for internally managed funds).

Prudential Indicators and Compliance Issues

19. The Council is required by the Prudential Code (for Capital Finance in Local Authorities) to report the actual prudential indicators after the year end. Certain of these indicators provide either an overview or a limit on treasury activity, and these are shown below in Table 3 below:-

Table 3: Net Borrowing and Capital Financing Requirement 2008/09

	2008/09 Budget Indicator £M	2008/09 Outturn Indicator*1*2 £M	Change £M
Net Borrowing/(Investment) position	+1.859	(3.641)	(5.500)
Capital Financing Requirement – 31st March	+14.523	+10.017	(4.506)

*1 – Comprises long term debt of £9.859m less investments of £13.500m
*2 – The Capital Financing Requirement Outturn is an estimate at this stage as the Council's Capital Account has not yet been finalised

20. The Capital Financing Requirement (CFR) shows the Council's underlying need to borrow for a capital purpose, and this is a gauge for the Council's debt position shown above.

21. In order to ensure that over the medium term borrowing net of investments will only be for a capital purpose, net borrowing should not, except in the short term, exceed the CFR. As Table The CFR at 31st March 2009 is £10.017m so even without the additional prudential borrowing planned in the period 2009/12, for 2008/09 plus the expected changes to the CFR over 2008/09 and 2009/10. The table above highlights that it is anticipated the Council will comply with this requirement for 2007/08 with net borrowing estimated to be some £10.161m lower than the capital financing requirement. Generally, rather than being a net borrower of funds, the Council is a net investor of surplus resources.

22. Ensuring that actual external debt remains affordable, prudent and sustainable by the Council is a fundamental requirement of the Prudential Code which requires the Council to establish an Authorised Limit and an Operational Boundary for the overall quantum of actual debt. The Authorised Limit is the "Affordable Borrowing Limit" required by s3 of the Local Government Act 2003. The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or over the Boundary are acceptable subject to the Authorised Limit not being breached.

23. Table 4 below shows the Council's gross borrowing position at 31st March 2009 compared to both the Authorised Limit and the Operational Boundary:-

Table 4: Performance Against Authorised Limit and Operational Boundary

	2008/09 Outturn Indicator £M
Authorised Limit	12.0
Operational Boundary	10.0
Actual Gross Borrowing Position	11.9

24. Whilst table 4 above shows the year-end position, provided at **Appendix A** is a graph that shows performance against the limits for 2008/09 as a whole. As **Appendix A** indicates, on various occasions between November 2008 and March 2009, the Council exceeded the operational boundary by varying amounts as part of the overall cashflow strategy. Under the Prudential Code for Capital Finance in Local Authorities, it is permissible for the occasional, but not sustained, breaches in the operational boundary as was the case in the latter part of 2008/09. At no time did the Council exceed the Authorised Limit of £12m and therefore the Council did comply with the prudential limits for external debt during 2008/09.

25. The Executive should note that as part of the Treasury Strategy for 2009/10, both the Authorised Limit and the Operational Boundary were increased to reflect the extent to which the Council's borrowing will change over the medium term. Tables 5 and 6 below are an extract from the Treasury Strategy report to the Executive in March 2009.

Table 6: Authorised Limit for External Debt

	2008/09	2009/10		2010/11	2011/12
	£m Estimate	£m Estimate (to 31/10/09)	£m Estimate (from 1/11/09)	£m Estimate	£m Comparator
Borrowing	12.00	14.00	12.00	14.00	15.00
Other long term liab	-	-	-	-	
Total	**12.00**	**13.00**	**12.00**	**14.00**	**15.00**

Table 7: Operational Boundary for External Debt

	2008/09	2009/10		2010/11	2011/12
	£m Estimate	£m Estimate (to 31/10/09)	£m Estimate (from 1/11/09)	£m Estimate	£m Comparator
Borrowing	10.00	12.00	10.00	12.00	13.00
Other long term liab	-	-	-	-	-
Total	**10.00**	**12.00**	**10.00**	**12.00**	**13.00**

Banking Facilities

26. The Council currently obtains its banking facilities from Lloyds TSB Bank Plc. The cost of the contract with Lloyds in 2008/09 was £11,369 (in comparison to a revised budget of £12,000).

27. During the year, periodic meetings were held with Bank officials to discuss issues of mutual interest and these are ongoing. The service provided by Lloyds TSB Bank Plc includes an overdraft facility of £500,000. There are occasions when it is more cost effective for the Council to utilise the facility during the year rather than call back existing investments.

28. Regular monitoring is undertaken of the Council's cash balances with a particular focus on ensuring that all surplus cash is, where possible, invested in accordance with the Council's Annual Investment Strategy. As a target, the Council aims to have an average cash balance in the range of +/-£50k. **Appendix F** shows performance for 2008/09 where, on average, the the cash balance was £9k.

External Advisors

29. The Council retains Sector Treasury Services as its treasury management advisors at a cost of c£8,776pa.

30. Regular meetings are held with Sector to assess the Council's progress in relation to the Treasury Management Strategy. In addition to daily advice on issues such as PWLB Rates, Sector provides the Council with a regular stream of information on treasury management and capital financial issues. Sector also assist the Council with:-

    - the preparation and review of the Annual Treasury Management Strategy;
    - advice on Treasury Management Practice notes and associated Schedules; and
    - monthly reviews of the Counterparty lending list in the light of the changes to investment regulations.

31. There are no matters of concern to report with the current arrangement with Sector although the level of service provided will continue to remain under review.

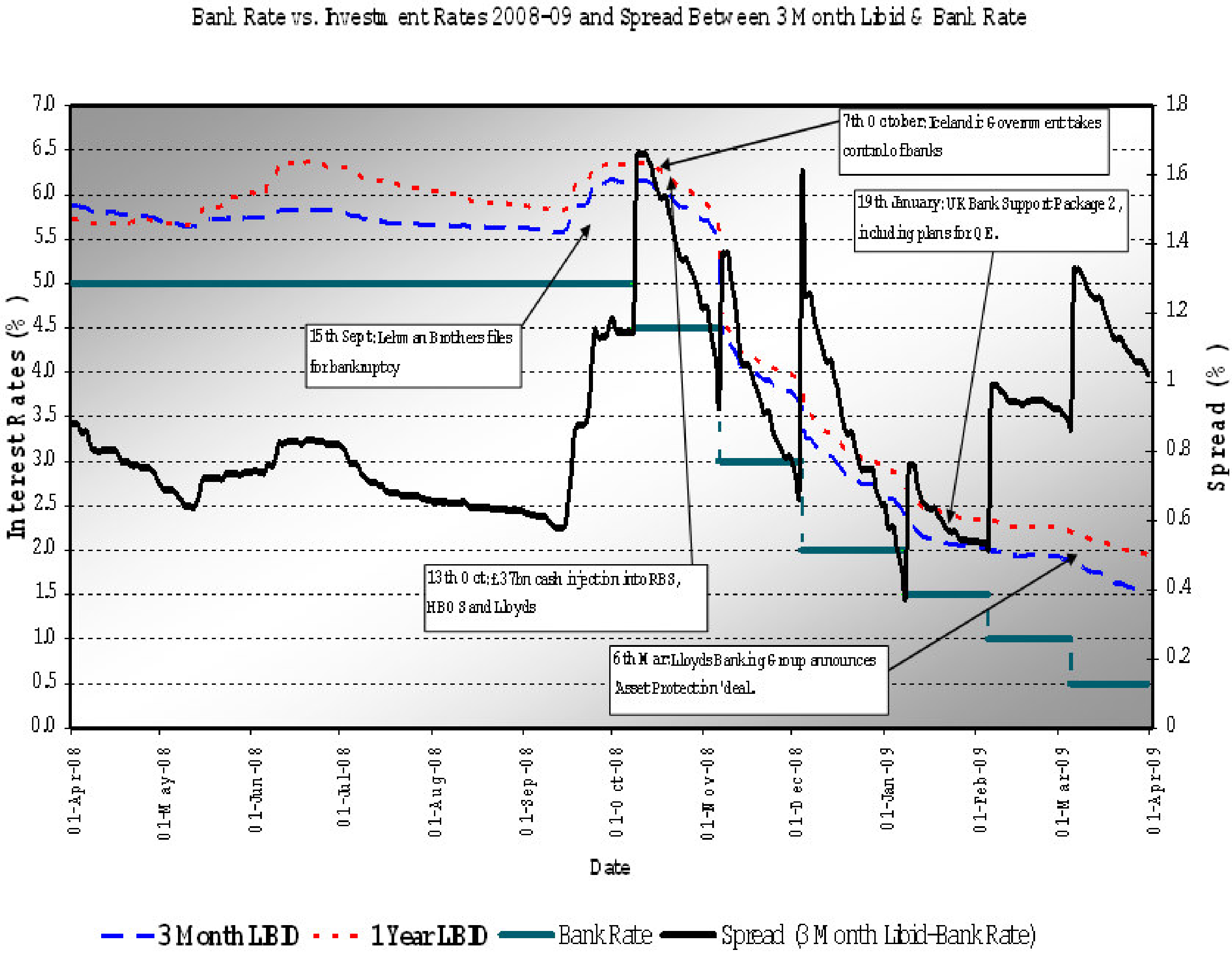
Appendices

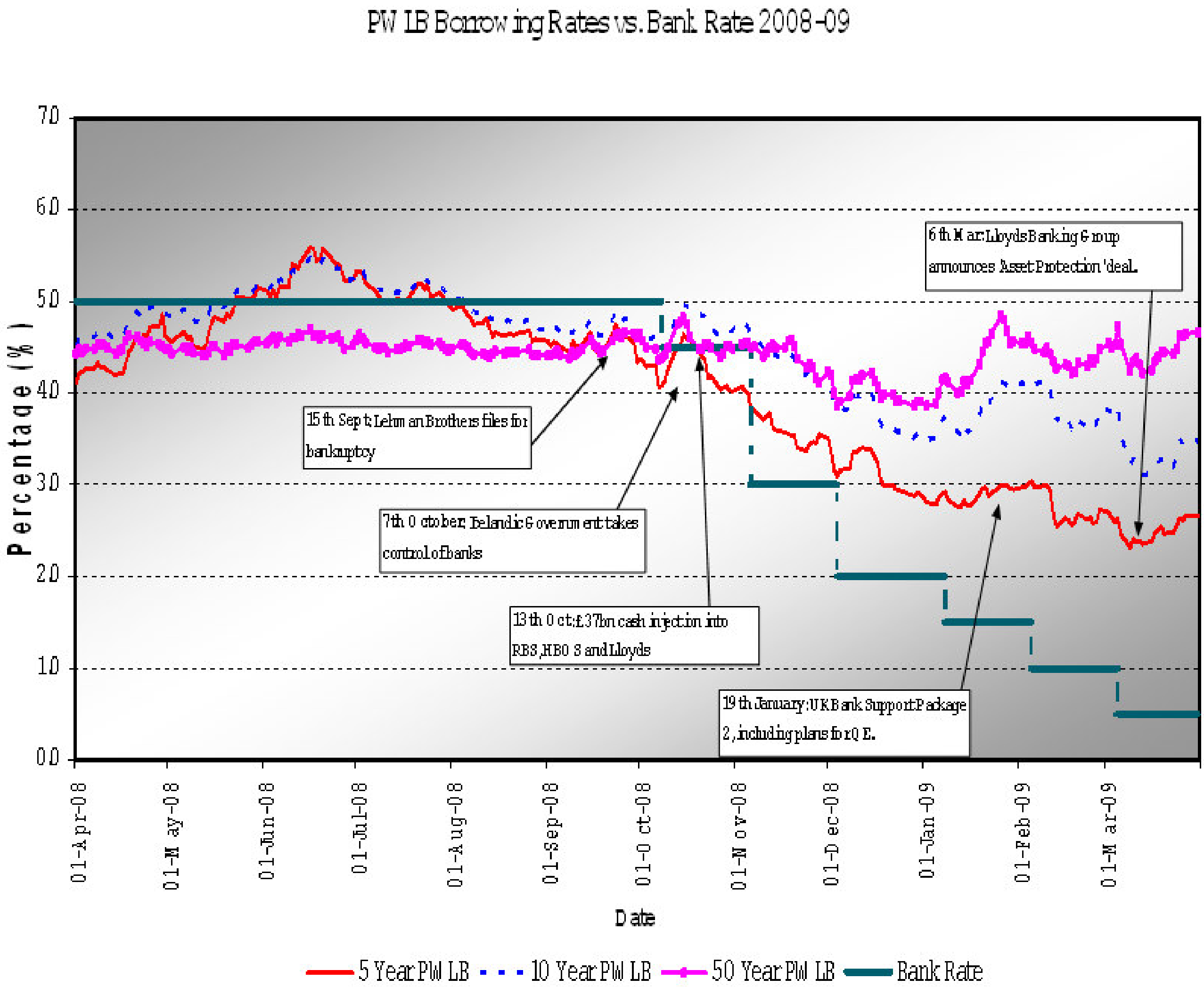
Appendix A - Economic Commentary 2008/09
Appendix B - Analysis of Long/Short Term Borrowing compared to Borrowing Limits 2008/09
Appendix C - Maturity Structure of current long term debt
Appendix D - Investment Returns 2008/09
Appendix E - Investment Balances 2008/09
Appendix F - Daily Cashflow Balances 2008/09

Appendix A

Economic Commentary 2008/09

1. In a year that can only be described as unparalleled and extraordinary the Annual Treasury Report for 2008/09 is summarised in the graphs below. These graphs show the major events of the financial year and the impact they had on both PWLB and investment rates. The financial crisis, commonly known as the 'credit crunch', had a major downward impact on the levels of interest rates around the world. Although interest rates initially fell sharply in the US they were followed, eventually, by the Bank of England.





2. On 1st April 2008 Bank Rate was 5% and the Bank of England was focused on fighting inflation. Market fears were that rates were going to be raised as CPI, the Government's preferred inflation target, was well above the 2% target (two years ahead). The money market yield curve reflected these concerns with one year deposits trading well above the 6% level. PWLB rates in both 5 and 10 years edged above Bank Rate during the summer as markets maintained the belief that inflation was the major concern of the monetary authorities. The money markets were reflecting some concerns about liquidity at this time and, as shown in the graph, the spread between Bank Rate and 3 month LIBOR was greater than had historically been the case.

3. This phase continued throughout the summer until the 15th September when Lehman Brothers, a US investment bank, was allowed to file for bankruptcy in the total absence of any other institution being willing to buy it due to the perceived levels of toxic debt it had. This event caused a huge shock wave in world financial markets and threatened to completely destabilise them. As can be seen from the charts this also led to an immediate spike up in investment rates as markets grappled with the implications this might have on other financial institutions, their credit standing and indeed their viability.

4. On 7th October the Icelandic government took control of their banks and this was followed a few days later by the UK government pumping a massive £37bn into three UK clearing banks, RBS/HBOS/Lloyds, as liquidity in the markets dried up. The Monetary Policy Committee meantime had reduced interest rates by 50bp on 9th October. This had little impact on 3 month LIBOR, however, as the spread, or 'disconnect' as it became known, against Bank Rate widened out. On the other hand the short end of the PWLB fell dramatically as investors, very concerned about their counterparty limits post the Icelandic banks' collapse, fled to the quality of Government debt forcing yields lower.

5. Market focus now shifted from inflation concerns to concerns about recession, depression and deflation. Although CPI was still well above target it was seen as no barrier to interest rates being cut further. The MPC duly delivered another cut in interest rates in November, this time by an unprecedented 1.5%. Investors continued to pour money into Government securities across the curve, at the front end because of credit concerns and the longer end because of the economic consequences reducing inflation, driving yields in 10 year PWLB temporarily below 4% and 5 years to around 3.5%. In December as the ramifications of the 'credit crunch' became increasingly clear the Bank of England cut interest rates to 2%-a drop this time of 1%. The whole interbank yield curve shifted downwards but the 'disconnect' at the short end remained very wide, negating to some degree the impact of the cuts in Bank Rate. 50 year PWLB rates dropped below 4% at the turn of the year, marking the low point, as it turned out, in this maturity.

6. The New Year of 2009 brought little relief to the prevailing sense of crisis and on 8th January the MPC reduced rates by 0.5% to 1.5%, a record low. More Government support for the banking sector was announced on 19th January 2009. The debt markets had a sharp sell-off at this stage as they took fright at the amount of gilt issuance likely to be needed to finance the help provided to the banks. There was also discussion about further measures that could be introduced to kick start lending and economic activity. These included quantitative easing by the Bank of England, effectively printing money.

7. In February 2009 the MPC adopted the traditional method of monetary easing by cutting interest rates again by 0.5% to 1%. Interbank rates drifted down with the spread in the 3 months still well above Bank Rate. In early March Lloyds Banking Group, which now included HBOS, took part in the Government's Asset Protection scheme. The MPC cut interest rates yet again to 0.5% and announced the quantitative easing scheme would start soon. This scheme would focus on buying up to £75bn of gilts in the 5-25 year maturity periods and £10 -15bn of corporate bonds. This led to a substantial rally in the gilt market, particularly in the 5 and 10 year parts of the curve, and PWLB rates fell accordingly. Finally at the end of March it was announced that the Dunfermline Building Society had run into difficulties and its depositors and good mortgages were taken over by Nationwide whilst the Treasury took on its doubtful loans.

8. The financial year ended with markets still badly disrupted, the real economy suffering from a lack of credit, short to medium term interest rates at record lows and a great deal of uncertainty as to how or when recovery would take place. Investment income returns have been badly hit but lower borrowing rates in short to medium periods had allowed indebted local authorities to benefit.