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CABINET – 6 JULY 2009 PORTFOLIO: FINANCE AND EFFICIENCY

ANNUAL REPORT ON THE TREASURY MANAGEMENT SERVICE AND ACTUAL PRUDENTIAL INDICATORS 2008/09

1. INTRODUCTION

1.1 The annual treasury report is a requirement of the Council's reporting procedures and covers the treasury activity for 2008/09. The report also covers the actual Prudential Indicators for 2008/09 in accordance with the requirements of the Prudential Code.

2. BACKGROUND

2.1 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 (although no restrictions were made in 2005/06);
- 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 DCLG has issued Investment Guidance to structure and regulate the Council's investment activities.

2.2 This Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Sector and operates its treasury management service in compliance with this Code and the above requirements. These require that the prime objective of the treasury management activity is the effective management of risk, and that its borrowing activities are undertaken in a prudent, affordable and sustainable basis.

2.3 The Code requires as a minimum the regular reporting of treasury management activities to:

- Forecast the likely activity for the forthcoming year (in the Annual Treasury Strategy Report); and
- Review actual activity for the proceeding year (this report).

2.4 This report sets out the information in the following appendices: -

Appendix 1

- A summary of the treasury strategy agreed for 2008/09;
- A summary of the economic factors affecting the strategy over 2008/09;
- The decisions taken and performance of the treasury service and their revenue effects;
- The Council's treasury position at 31 March 2009;

Appendix 2

- The main Prudential Indicators and compliance with limits;
- Performance indicators set for 2008/09;
- Risk and performance.

3. CRIME AND DISORDER, ENVIRONMENTAL AND EQUALITY & DIVERSITY IMPLICATIONS

3.1 None arising directly from this report.

4. COMMENTS FROM CORPORATE OVERVIEW PANEL

4.1 The Panel supported the recommendations below.

5. PORTFOLIO HOLDER COMMENTS

5.1 The Portfolio Holder supports the annual report on the Treasury Management Service and the Actual Prudential Indicators for 2008/09. He is pleased that the Council continues to be debt free and that it is forecast to remain so.

6. RECOMMENDATIONS

6.1 The Cabinet are recommended to consider and note this report.

Further Information Please Contact:	**Background Papers:**
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APPENDIX 1

TREASURY MANAGEMENT PERFORMANCE - 1 APRIL 2008 TO 31 MARCH 2009

1. INTRODUCTION

This appendix sets out the performance for the Council's own treasury management activities and those of the in-house managed fund.

2. TREASURY STRATEGY SUMMARY FOR 2008/09

2.1 Borrowing Strategy

The borrowing strategy for 2008/09 estimated that: -

- Bank base rates would average 4.8% for the year;
- Long-term borrowing to meet capital expenditure would not be undertaken as the preference expressed by Members was that the Council should remain debt-free for the time being;
- The Council would borrow temporarily for cash flow purposes;
- Interest payments of £40,000 were estimated.

2.2 Investment Strategy

The investment strategy for 2008/09 estimated that: -

- It is likely that investments would be made for longer periods with fixed rates to lock in good value and security of return if opportunities arose, subject to over riding credit counterparty security;
- Interest earnings on the Council's temporary cash flow investments was estimated to be £712,000;
- Interest earnings on the In-house Managed Fund was estimated to be £660,000;

3. SUMMARY OF ECONOMIC FACTORS

3.1 Following the Credit Crunch of 2007/08 market conditions remained nervous. The US authorities had cut interest rates in March. The Bank of England and European banks had resisted, mainly because of inflation concerns.

3.2 The failure of US investment bank Bear Stern (rescued by JP Morgan Chase), increased fear and suspicion in the banking sector.

3.3 Banks possessed sufficient liquidity but their reluctance to lend to each other meant that money markets failed to function normally.

3.4 The Bank of England announced a Special Liquidity Scheme to aid liquidity in April. The Scheme proved popular and the sum injected into the market was £100bn, twice the amount anticipated. However, banks were still reluctant to lend and a very wide margin between the official bank rate and money market rates persisted.

3.5 During the summer conditions began to ease gradually and there were signs of a return to more normal market conditions.

3.6 In mid-September the US authorities allowed investment bank, Lehman Brothers, to fail and rescued the country's largest mortgage lenders.

3.7 Market liquidity dried up completely and well regarded institutions were driven towards bankruptcy. UK bank HBOS was unable to raise sufficient funding and was rescued by Lloyds TSB. Bradford and Bingley was nationalised.

3.8 Smaller banks were the hardest hit. The Irish Government announced guarantees for its country's banks. Icelandic banks failed in early October and deposits were frozen.

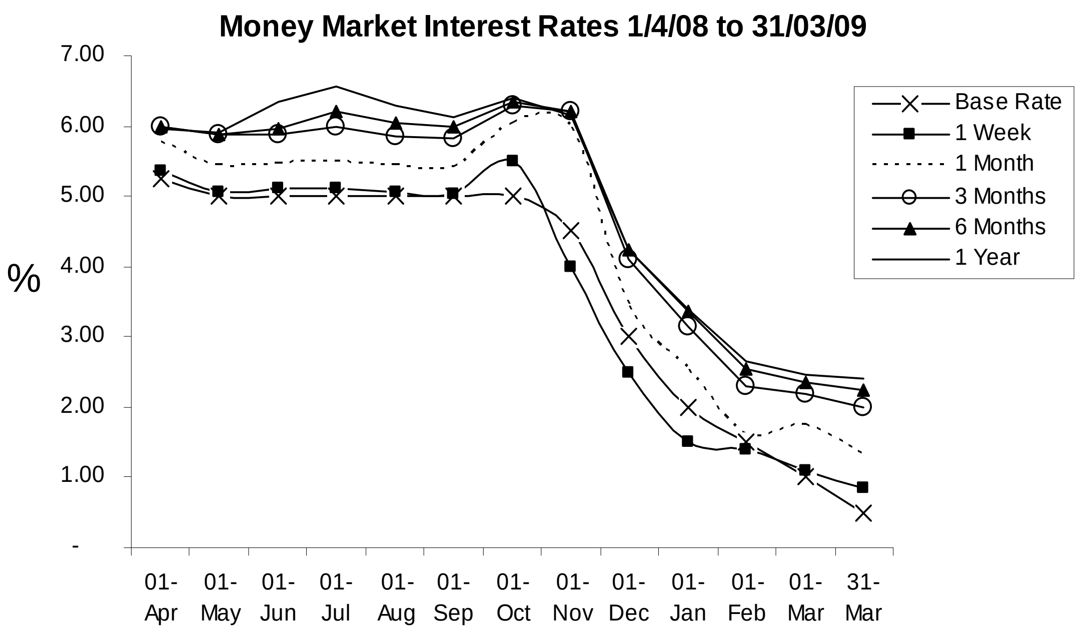
3.9 The financial markets descended into crisis amid concerns over a total collapse of the world's financial system. Governments, including the UK, launched rescue programmes. The UK programme included the recapitalisation of many of the high street banking groups by partial nationalisation and further cash injections.

3.10 In the US the rescue included the partial nationalisation of Citigroup and official interest rates were cut to a range between zero and 0.25%.

3.11 In the UK, the Bank of England initiated a series of interest rate cuts in the knowledge that the UK economy was declining into deep recession and inflation was set to fall sharply.

3.12 In March the Bank of England instigated a series of reverse gilt auctions, known as quantitative easing, to increase money supply in the economy. By the end of the year the bank base rate had been cut to an historic low of 0.5%.

3.13 The following chart shows how the money market interest rates reduced over the year.



3.14 The movements in the bank base rate during the year were as follows:

Date	Bank Base Rate
At 1 April 2008	5.25%
11 April 2008	5.00%
9 October 2008	4.50%
7 November 2008	3.00%
5 December 2008	2.00%
9 January 2009	1.50%
6 February 2009	1.00%
6 March 2009	0.50%

3.15 Analysts forecast that there will be no further bank base rate reductions and that the rate will remain stable for during the summer and autumn of 2009. The next movement in bank base rates is forecast to be an increase in the winter of 2009.

4. LONG-TERM BORROWING

4.1 The Council had no existing long-term borrowing at 1 April 2008 and no long-term loans were raised during the year.

5. TEMPORARY BORROWING AND INVESTMENT

5.1 Borrowing

There were no temporary loans outstanding on 1 April 2008.

Ten temporary loans were raised during the year for cash flow purposes. The loans were for periods up to 18 days and for amounts up to £2.0 m.

There were no temporary loans outstanding at 31 March 2009.

5.2 Temporary Cash flow Investment

5.2.1 The original estimate for 2008/09 for interest receivable on temporary investments was £712,000 based on an anticipated earnings benchmark of 5.25% for the year. The actual interest receivable was £1,121,000 with an average interest rate of 5.11%; a variation of £409,000.

5.2.2 The main cause of this variation was due to an underspend of revenue expenditure of £1.2m for the year, and an underspend and the rephasing of capital expenditure of £2.85m, resulting in an increase in interest earnings of £200,000. At 1 April 2008 the Council's balances were higher than had been anticipated when the original budgets were set and this also caused earnings to be increased by an estimated £267,000. The remaining variation was because of a lower than anticipated interest rate for the year caused both by a change in expectation of interest rate movements and the credit crisis (-£58,000).

5.2.3 Of this variation £381,000 was reported to Cabinet during the year. The increase of £28,000 from the figure already reported was due to an unanticipated underspend in the last quarter to 31 March 2009.

5.2.4 The actual interest earned on temporary investments for the year was equivalent to an annual rate of return of 5.11%.

5.2.5 The average rate of 7 day LIBID, the interest rate used for benchmarking the Council's interest earnings for 2008/09, was 3.69%. Therefore, the interest earned on temporary investments exceeded the average rate of interest money market interest rate.

5.2.6 All temporary investments have been made in accordance with the parameters set within the Council's Treasury Policy Statement.

5.2.7 The table below shows the list of temporary investments at 31 March 2009.

Borrower	**Amount £**	**Interest Rate %**
Darlington BS	1,000,000	2.55
Ipswich BS	500,000	2.25
Ipswich BS	500,000	2.25
Saffron BS	750,000	2.25
West Bromwich BS	750,000	1.10
Stroud & Swindon BS	2,000,000	2.05
Newcastle BS	3,000,000	2.05
Total	**8,500,000**	

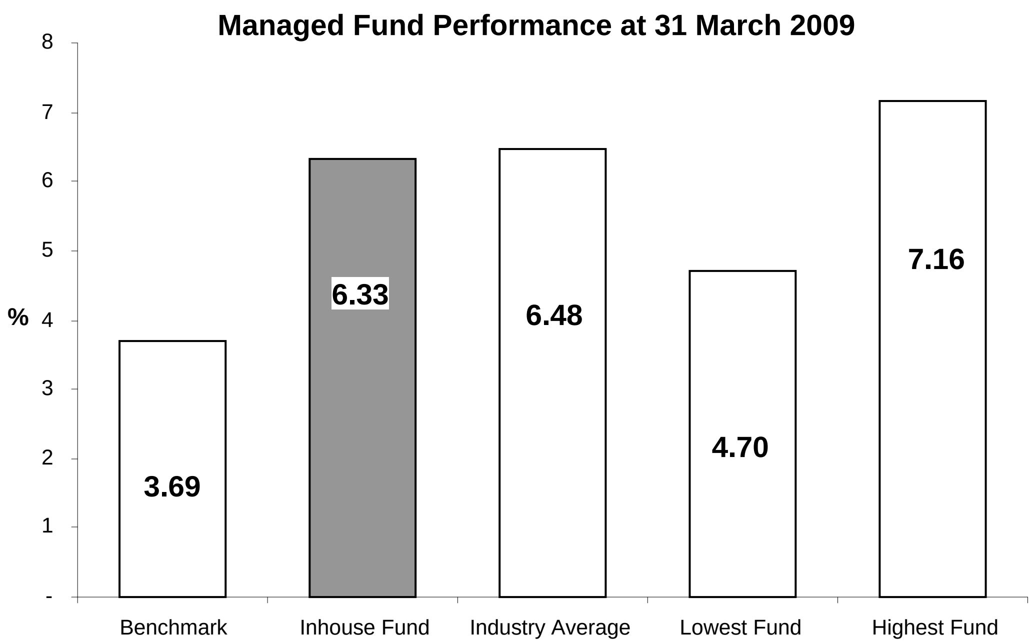
6. MANAGED FUNDS

6.1 At 1 April 2008 the Council had £12m invested and managed in-house by council staff.

6.2 The fund is expected to achieve a benchmark return during the year. The benchmark is based on the return the Council could achieve by investing the funds on a short-term basis and compounding the interest weekly.

6.3 The compounded benchmark return for the period 1 April 2008 to 31 March 2009 was 3.76%. The in-house fund achieved a rate of return of 6.33%.

6.4 The chart below shows the difference in performance of the funds against the benchmark, the industry average and other fund managers.



6.5 The performance of the in-house fund was higher than the benchmark.

6.6 The in-house fund earnings were lower than the industry average.

6.7 Results to 31 March 2009 are summarised as follows: -

	In-house Fund %	**Industry Average %**
Actual Return	6.33	6.48
Benchmark Return	3.76	3.76
	£000	**£000**
Actual Return	760	778
Benchmark Return	451	451
Return above/(-)below benchmark	309	327

6.8 The value of the interest earned on the in-house fund as at 31 March 2009 was £309,000 above the benchmark figure as shown at paragraph 6.7 and £18,000 lower than the industry average.

6.9 The original estimate for the managed fund interest earnings for 2008/09 was £660,000 based on a budgeted return of 5.50%.

6.10 A revised forecast for interest earnings of £758,000 for 2008/09 was reported during the year based on a return of 6.32%.

6.11 The actual earnings for 2008/09 were £760,000 and the rate of return 6.33%.

6.12 Investment Portfolio Strategy

6.12.1 The in-house fund is invested in cash deposits. Gilts and CD's are not used as the fund is managed by council staff.

6.12.2 At the start on the year the portfolio was invested in instruments with interest rates averaging 6.18%.

6.12.3 At the beginning of the year the anticipation was that interest rates would rise with the peak at 5.5% before falling back to sub 5% rates.

6.12.4 In the summer the credit crisis continued keeping interest rates high. Money Market rates were forecasting bank base rates in excess of 6% and deposits were made for periods of between 6 months and one-year when the interest rates were at their highest.

6.12.5 The eventual crisis in the global banking system forced interest rates to record low levels.

6.12.6 The fund was invested in deposits earning an average of 5.22% at the year end. This average rate will reduce through 2009/10 as the current investments mature and are replaced with those of a much lower return.

7. TREASURY POSITION AT 31 MARCH 2009

The following table shows the treasury position at the 31 March 2009 compared with the previous year.

	31 March 2008		31 March 2009	
	Principal	**Average Rate**	**Principal**	**Average Rate**
Total Debt	**£m**	**%**	**£m**	**%**
In-house Managed Fund				
Variable Interest Rate	£4.50m	6.2%	£9.00m	4.7%
Fixed Interest Rate	£7.50m	6.1%	£3.00m	6.7%
Total Managed Funds	**£12.00m**	**6.2%**	**£12.0m**	**5.2%**
Temporary Cash-flow Investments	£7.50m	5.2%	£8.50m	2.1%
Call Account (variable interest rate)	£0.50m	4.8%	£0.05m	0.1%
Total Investments	**£20.00m**	**5.8%**	**£20.55m**	**2.0%**

APPENDIX 2

PRUDENTIAL INDICATORS AND COMPLIANCE ISSUES TO 31 MARCH 2009

1. INTRODUCTION

1.1 The Council is required by the Prudential Code to report the actual prudential indicators after the year-end.

1.2 The following table, at Paragraph 2, provides a schedule of all the mandatory prudential indicators.

1.3 Certain of these indicators must be compared to others and are detailed later in this appendix.

2. ESTIMATED AND ACTUAL TREASURY POSITION AND PRUDENTIAL INDICATORS

2.1 The following table compares the actual figure for 2008/09 with the original indicator for 2008/09 and the actual figure for 2007/08.

2.2 The original indicator for 2008/08 is the same as was included in the Treasury Strategy Report 2008/09.

		2007/08 Actual £000	**2008/09 Original Indicator £000**	**2008/09 Actual £000**
1	**Capital Expenditure**	11,747	15,525	12,668
2	**Capital Financing Requirement (CFR) at 31 March**			
	Housing	1,897	1,897	1,897
	Non Housing	4,642	5,704	4730
	Total	**6,539**	**7,601**	**6,627**
3	**Treasury Position at 31 March**			
	Borrowing	0	0	0
	Other long term liabilities	0	0	0
	Total Debt	**0**	**0**	**0**
	Investments	20,000	11,100	20,550
	Net Borrowing/Investments (-)	**-20,000**	**-11,100**	**-20,550**
4	**Authorised Limit (against maximum position)**	Maximum 2,500	Limit 25,000	Maximum 2,000
5	**Operational Boundary**	2,500	2,000	2,000
6	**Ratio of financing costs to net revenue stream**	-4%	-2%	-2%
7	**Incremental impact of capital investment decisions on the Band D council tax**	£ 2.81	£ 7.22	£ 6.25

8	**Incremental impact of capital investment decisions on the housing rent levels**	£ -1.31	£ 1.32	£ 0.76
9	**Upper limits on fixed interest rates (against maximum position)**	**Maximum** 99%	**Maximum** 100%	**Maximum** 100%
10	**Upper limits on variable interest rates (against maximum position)**	**Maximum** 26%	**Maximum** 50%	**Maximum** 8%
11	**Maturity structure of fixed rate borrowing (against maximum position)**			
	Under 12 months	100%	**Upper Limit** 100%	100%
	12 months to 2 years	0%	100%	0%
	2 years to 5 years	0%	100%	0%
	5 years to 10 years	0%	100%	0%
	10 years and above	0%	100%	0%
12	**Maturity structure of variable rate investments (against maximum position)**			
	Under 12 months	100%	**Upper Limit** 100%	100%
	12 months to 2 years	0%	50%	0%
	2 years to 5 years	0%	50%	0%
13	**Estimated maximum principal funds invested (against maximum position)**	**Maximum** 46,441	**Maximum** 42,000	**Maximum** 47,015

2.3 Any indicators that were exceeded were guideline limits only. There were no breaches of statutory limits during the year.

2.4 In addition to the above the Council is required as a Prudential Indicator to:

- Adopt the CIPFA Code of Practice. The compliance for this indicator is shown at paragraph 2.2 in the body of the report.

- Ensure that over the medium term borrowing will only be for a capital purpose (i.e. net external borrowing is less than the CFR). The compliance for this indicator is shown at paragraph 3.1 below.

3. LIMITS TO BORROWING ACTIVITY

3.1 Net external borrowing

	31 March 2008 **Actual**	**31 March 2009 Original Indicator**	**31 March 2009** **Actual**
Net borrowing position	**-£20.0m**	**-£11.1m**	**-£20.5m**
Capital Financing Requirement	**£6.5m**	**£7.6m**	**£6.6m**

The Capital Financing Requirement (CFR) shows the Council's underlying need to borrow for a capital purpose, and this is an indication of the Council's debt position. In order to ensure that borrowing net of investments will only be for a capital purpose, net borrowing should not exceed the CFR for 2008/09.

The table above shows that the Council has complied with this requirement.

3.2 Borrowing Limits

	2008/09
Authorised Limit	**£25.0m**
Operational Boundary	**£2.0m**
Maximum gross borrowing position during the year	**£2.0m**
Minimum gross borrowing position during the year	**£0.0m**

The Authorised Limit must not be breached. The table demonstrates that during 2008/09 the Council has maintained gross borrowing within its Authorised Limit.

The Operational Boundary is the expected average borrowing position of the Council during the year, and periods where the actual position is either below or over the Boundary is acceptable subject to the Authorised Limit not being breached.

4. TREASURY SERVICE PERFORMANCE INDICATORS FOR 2008/09

The treasury service has set the following performance indicators:

- The In-house fund performance should be higher than a benchmark of the 7-day LIBID rate compounded weekly.

5. RISK AND PERFORMANCE

5.1 The Council has complied with all of the relevant statutory and regulatory requirements that 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 that its capital expenditure is prudent, affordable and sustainable, and that its treasury practices demonstrate a low risk approach.

5.2 The Council is aware of the risks of passive management of the treasury portfolio and has proactively managed the investments over the year.

5.3 Shorter-term market rates and likely future movements of interest rates predominantly determine the Council's investment return. These returns can therefore be volatile and, whilst the risk of loss of principal is minimised through the annual investment strategy, accurately forecasting future returns can be difficult.

5.4 Section 6 of appendix 1 shows the returns for 2008/09.

5.5 For investments managed in-house returns have been higher than the benchmark and there is a low risk associated with these types of investments.