Annual Treasury Management Report 2008/09

Finance and Administration Committee 24 September 2009 Item 6

Committee	**Finance and Administration Committee**	**Agenda Item**
Date	24 September 2009	**6**
Title	Annual report on Treasury Management and Prudential Indicators 2008/09.	
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Summary

The annual treasury report is a requirement of the Council's reporting procedures and has to be approved by the 30th September following the end of the financial year. It covers the treasury activity for 2008/09, and the actual Prudential Indicators for 2008/09.

Recommendations

The Committee is recommended to:

Note and approve the actual 2008/09 prudential indicators within the report.

Note and approve the treasury management outturn for 2008/09.

Scope

This report is prepared in accordance with the CIPFA Treasury Management Code and the Prudential Code.

Presents details of capital financing, borrowing, debt rescheduling and investment transactions during the year.

Gives details of the outturn position on treasury management transactions in 2008/09.

Confirms compliance with treasury limits and Prudential Indicators.

Impact

Communication/Consultation	None
Community Safety	None
Equalities	None
Finance	This report sets out the treasury management activities during 2008/09, the interest earned on the Council's balances and its compliance with the Prudential Indicators
Human Rights	None
Legal implications	None
Ward-specific impacts	None
Workforce /Workplace	None

Background

Treasury Management in Local Government is governed by the CIPFA Code of Practice on Treasury Management in the Public Services and in this context is the "management of the Council's cash flows, its banking and its capital market transactions; the effective control of the risks associated with those activities and the pursuit of optimum performance consistent with those risks". This Council has adopted the Code and complies with its requirements.

Uttlesford District Council approves the treasury strategy and it receives a strategy report at the beginning of each financial year identifying how it is proposed to finance capital expenditure, borrow and invest in the light of capital spending requirements, interest rate forecasts and economic conditions. The Finance and Administration Committee monitors the implementation of the treasury strategy and activity and reports are received at each meeting, including this annual treasury outturn report.

The Prudential Capital Finance System came into force on 1st April 2004. The Council determines at a local level its capital expenditure and can borrow or use alternative financing methods to finance capital spending provided that capital plans are demonstrably affordable, prudent and sustainable, and options appraisal supports asset management planning. The Prudential Code for Capital Finance in Local Authorities requires indicators to be set – some of which are limits – for a minimum of three forthcoming financial years.

The DCLG's Guidance on Local Government Investments in England came into effect on 1st April 2004. The emphasis of the Guidance is on security and liquidity of invested monies. The Council is required to establish an annual investment strategy and to determine 'specified' and 'non specified' investments for use during the year.

Economic Outlook for 2008/09

At the time of determining the Treasury Management Strategy Statement for 2008/09 in February 2008, the outlook for the economy and interest rates was as follows:

Inflation and the outlook for inflation gave cause for concern with the price of oil having reached $100/barrel. Elevated food prices, fuel and transportation costs were expected to put upward pressure on Consumer Price Inflation. The effects of the credit crunch and the ensuing market turmoil experienced in the second half of 2007 were however expected to weaken UK business activity and growth. Tighter credit terms and availability was expected to weigh negatively on the UK housing market and on consumer spending.

The Bank of England had cut rates to 5.25% in January 2008. Further cuts were expected taking the Bank Rate to 4.75% in 2008 as stresses in financial markets and a deteriorating economic outlook increased the risks to growth.

The elevated short-dated Libor and Libid rates witnessed in Q4 2007 were expected to revert to more normal levels and reflect the outlook for the direction of interest rates.

The economy and events in 2008-09

Inflation / GDP : Inflation rose higher than anticipated; CPI for May breached the Monetary Policy Committee's 3% outer boundary; CPI for August reached a high of 4.7%. The price of oil reached nearly $145/barrel and food and commodity prices remained elevated. Higher levels of inflation did not however result in higher wage settlements as the spectre of slowing growth and deflation trumped concerns over inflation.
Economic conditions in the UK, Eurozone and US economies deteriorated rapidly into

the worst post-war recession. In the UK the HBOS measure of house prices slumped by 17.5% in FY 2008-09. The dearth of availability of secured and unsecured finance posed a significant risk to consumer and corporate spending. Unemployment rose to 6.7%. The tightening in credit conditions and the economic malaise became entrenched; this rapidly impacted on growth which fell nearly 3.8% over the 12-month period. The UK was headed for a long and deep recession.

2008 saw the worst upheaval in credit and financial markets for some decades. The stresses in the financial markets threatened to quickly turn the liquidity crisis into a solvency crisis. In August and September several banking and financial stocks fell victim to intense negative investor sentiment and even the prices of high-grade credit took on the characteristics of distressed debt.

The financial crisis reached boiling point following the collapse of Lehman Brothers in September. It ultimately prompted governments and central banks to act unilaterally to shore up their financial systems. These included bank bailouts and direct capital injections into banks and financial institutions. Lloyds TSB agreed to acquire HBOS; Cheshire and Derbyshire building societies individually approached Nationwide BS to be acquired by the latter. The government injected significant capital into Royal Bank of Scotland Group (it now owns over 70%) and the Lloyds Banking Group. Financial bailouts and support for banks were replicated in much of Europe and in the US, with increasing pressure from the regulatory authorities for banks to raise their capital ratios to survive the worst of the economic downturn.

Policy rates in the UK and US were rapidly cut to near zero. In the UK the Bank of England cut rates from 5% in April to 0.5% by March 2009. As interest rates had reached terminal levels but were not having much effect in reflating the economy, the Bank of England initiated its Quantitative Easing (QE) programme in March 2009 under which the Bank would buy back an initial £75bn of gilts over a 3-month period with the purpose of lowering gilt yields and ultimately borrowing costs for the UK corporate sector.

The government's projections for growth in the November Pre Budget Report were overly optimistic; it was soon apparent the shortfall in public finances would have to be made good through hefty gilt issuance, estimated in January to rise in excess of £120 bn in 2009-10. (The borrowing requirement is likely to be revised significantly higher in the Chancellor's Budget on 22 April 2009.)

It was not surprising that money market rates and gilts yields exhibited extreme volatility during the financial year. Money market rates spiked as the banking crisis intensified and confidence crumbled. 3-month Libor, a proxy for the direction of policy rates, climbed to a high of 6.4% in October; this despite markets' forecast that the Bank Rate was set to fall below 3%. Due to the distressed state of the markets, short-term money market rates remained elevated despite the large cuts in the Bank Rate and only began to move down towards the Bank Rate in early 2009 when, following efforts to recapitalise banks, some stability seemed to have returned to the banking and financial sector.

Long-term Borrowing & other Long-term Liabilities

	Balance At 1/4/2008 £m	Maturing loans £m	Loan Repayment £m	New Borrowing £m	Balance at 31/3/2009 £m
Long-term Borrowing	-	-	-	-	-
Temporary Borrowing	-	-	-	-	-
Total borrowing	**-**	**-**	**-**	**-**	**-**
Other long-term liabilities	1.60	-	-0.24	-	1.36
TOTAL EXTERNAL DEBT	**1.60**	**-**	**-0.24**	**-**	**1.36**

The Council had no longer term debt at the beginning of the Prudential regime on 1st April 2004. Although there are now no significant advantages in remaining "debt-free", the Council's decision was not to borrow long-term monies to finance its capital spending, relying instead on government grants / usable capital resources / revenue contributions, etc. The need to borrow in accordance with the Council's requirement will be kept under review in 2009-10.

Capital Expenditure Financing

Source	Amount £000
Government Grants	228
Usable Capital Resources	2,302
Major Repairs Reserve	1,864
S106	38
TOTAL	**4,432**

Annual Investment Strategy and Outturn

The Council held average cash balances of £14.881m during the year. These represent working cash balances / capital receipts and the Council's reserves.

The ODPM's Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles. Having assessed the risks associated with the various potential investment instruments, the Council determined the 'specified' and 'non-specified' investments it would use during the year. These decisions were taken at local level to suit the Council's particular circumstances, return aspirations and risk tolerances.

INVESTMENTS	Balance at 01/4/2008 £000	Reclassification in year £000	Impairment in year £000	Balance at 31/3/2009 £000
Money Market Lending (short-term)	2,262	(2,200)	-	3,006
Government deposit account	-	-	-	1,500
Allied Irish Treasury	2,427	-	-	-
Abbey National PLC	-	-	-	1,995
Bank of Scotland	4,009	-	-	1,000
Longer-term investments*	-	2,200	(514)	1,686
TOTAL INVESTMENTS	**8,698**	**-**	**(514)**	**9,187**

* The Landsbanki investment has been reclassified as a long-term investment as per LAAP bulletin 82.

The Council's existing investments are a combination of short-term investments and deposit accounts which reflect previous treasury management strategies and decisions. The mix of short-term investments and investments enables the Council to maintain an appropriate level of liquidity and enables it to mitigate re-investment risk (the risk that a large proportion of maturing investments is reinvested when interest rates are at a cyclical low).

Investment Income

The Council's investment income for the year was £0.637m compared to a budget of £0.420m. The variance was due to the prevailing money market rates of interest which were initially higher than forecast, primarily due to the financial crisis.

Icelandic Investment

In early October 2008 all three of Iceland's major banks (Glitnir, Kaupthing and Landsbanki) collapsed following their difficulties in re-financing their short-term debt coupled with a run on deposits. In the UK, the Financial Services Authority (FSA) put Kaupthing, Singer & Friedlander (the UK subsidiary of Kaupthing) and Heritable Bank (the UK subsidiary of Landsbanki) into administration. The Administrators will be seeking to find purchasers for, and will continue to manage, the banks' businesses and loan books to maximize recovery for creditors.

This Council had deposits of £2.2m with Landsbanki. The process of administration will determine the extent of any recoverable amount and also the timescale over which any such payments will be made. The Council will however be required under the SORP to account for the impairment of these financial assets in the 2008/09 Income and Expenditure Account. The DCLG published draft Regulations in December 2008 aimed at deferring the impact of impairment until 2010/11. The Council will then have the opportunity to apply to the DCLG for a capitalisation direction in that year, although no guarantee can be given that a direction will be granted. The granting of a capitalisation direction allows the impairment cost to be spread over a number of years.

Based on present information, the Administrators projections indicate a base case return to preferential creditors of 83%.

Minimum Revenue Provision (MRP)

There is now a statutory requirement to make a "prudent provision" for MRP (SI 2008 No.414). Statutory Guidance issued by the DCLG in March 2008 makes recommendations to local authorities on the interpretation of the term "prudent provision". Local authorities are to have regard to this Guidance which provides four options:

Option 1:	Regulatory Method
Option 2:	CFR Method
Option 3:	Asset Life Method
Option 4:	Depreciation Method

Options 1 and 2 can be used on all capital expenditure incurred before 1st April 2008 and on Supported Capital Expenditure on or after that date. Options 3 and 4 are considered prudent options for Unsupported Capital Expenditure on or after 1st April 2008 and can also be used for Supported Capital Expenditure whenever incurred.

The Council's has used Option 3 for 2008-09, this resulted in the Council making a £266,000 minimum revenue provision.

UDC makes minimum revenue payments to cover the capital cost of its long term liabilities (Waste service, finance lease)

Compliance with treasury limits and treasury-related Prudential Code indicators.

The Council implemented its treasury strategy within the limits and parameters set in its treasury policy statement and Prudential Indicators against the prevailing market opportunities as follows:

(a) Financing its capital spending from government grants / usable capital resources / revenue contributions, etc. rather than from external borrowing.

(b) Adhering to the paramount requirement of safeguarding the council's invested balances during a period of unprecedented money market dislocation; tightening the minimum credit criteria for lending in response to the credit crisis and maintaining adequate diversification between institutions; optimising investment returns subject to the overriding requirement of security and liquidity.

(c) Forecasting and managing cash flow and undertaking short-term borrowing and lending to preserve the necessary degree of liquidity.

Treasury-related Prudential Indicators

The Council at its meeting on 19th February 2008 approved the recommended Prudential Indicators for 2008/09.

Authorised Limit

This is the maximum amount of external debt that can be outstanding at one time during the financial year. The limit, which is expressed gross of investments, is consistent with the Council's existing commitments, proposals for capital expenditure and financing and with its approved treasury policy and strategy and also provides headroom over and above for unusual cash movements. This limit was set at £6.4m for 2008/09.

Operational Boundary

This limit is set to reflect the Council's best view of the most likely prudent (i.e. not worst case) levels of borrowing activity and is based on the Authorised Limit excluding the headroom for unusual cash movements. For 2008/09 the limit was set at £4.0m.

The levels of debt are measured on an ongoing basis during the year for compliance with the Authorised Limit and the Operational Boundary. The Council maintained its total external borrowing and other long-term liabilities within both limits; at its peak this figure was £1.6m.

Upper Limits for Interest Rate Exposure

These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. The exposures are calculated on a net basis, i.e. fixed rate debt net of fixed rate investments. The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.

	Estimated Original Budget £m	Estimated Revised Budget £m	Actual Maximum £m
Upper Limit for Fixed Rate exposure	11	20	15.2
Upper Limit for Variable Rate exposure	11	20	11.5

Maturity Structure of Fixed Rate borrowing

This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates. It is calculated as the amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate.

	Upper limit %	Lower limit %	Actual Borrowing as at 31/3/2009 £	Percentage of total as at 31/3/2009 %
under 12 months	-	-	-	-
12 months and within 24 months	-	-	-	-
24 months and within 5 years	-	-	-	-
5 years and within 10 years	-	-	-	-
10 years and above	-	-	-	-

Total principal sums invested for periods longer than 364 days

This indicator is set in order to allow the Council to manage the risk inherent in investments longer than 364 days. For 2008-09 this limit was set at £0m.

During 200809 the Landsbanki investment was reclassified as a long term investment, as it has now been invested for longer than 364 days.

Balanced Budget

The Council complied with the Balanced Budget requirement.

Change in external service providers

During 2008/09 the council re-tendered for its external treasury management advisory contract. The contract was awarded to Arlingclose Ltd.

Overall Conclusion

During 2008/09 the Council complied with its treasury management strategy and within its Prudential Indicators, apart from a minor technical breach regarding the split between fixed and variable interest rate investments. This breach was dealt with as part of revised budget when the limit on both sides of the split was raised from 11m to 20m.

Other items

At the end of March 2009 CIPFA's Treasury Management Panel issued an interim bulletin "Treasury Management in Local Authorities – Post Icelandic Collapse". CIPFA intends to revise both the Treasury Management Code and Guidance Notes in the light of some local authorities' exposures to the failed Icelandic banks. Formal guidance will follow after consultation on and publication of the revised Treasury Management Code.

The interim bulletin, which constitutes advice and does not have the status of formal guidance, reiterates treasury management objectives and risk (security, liquidity and yield risk). The bulletin treasury monitoring and corporate governance issues (involvement of portfolio holders / audit committees in treasury management policy setting), providing transparency on gross and net borrowing, skills, resources and training for treasury staff, counterparty lists, use of treasury management advisors, and benchmarking of treasury management performance.