Executive **17 November 2009**

Report of the Director of Resources

Treasury Management Monitor 2 Report

Summary of Report

1. This report updates the Executive on the Treasury Management performance for the period 1 April 09 to 30 September 2009 compared against the budget presented to Council on 21 February 2009.

2. The report highlights the economic environment for the first six months of the 2009/10 financial year and in relation to this reviews treasury management performance covering:

   - Short-term investments,
   - Long-term borrowing,
   - Venture Fund,
   - Treasury Management Budget.

Background

3. The Council's treasury management function is responsible for the effective management of the Council's cash flows, its banking, money market and capital transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

4. The Council approved the Treasury Management Strategy, budget and Prudential Indicators on 21 February 2009. This report monitors the Treasury Management activity for the first 6 months of 2009/10 and shows the change in the Treasury Management budget to 30 September 2009 and the forecast outturn position for the year.

Consultation

5. This report is for information and reporting on the performance of the treasury management function. The budget was set in light of the prevailing expenditure plans and economic conditions, based on advice from the Council's Treasury Management advisors.

Corporate Priorities

6. The Council has a priority to ensure value for money and efficiency of its services. Treasury Management aims to achieve the optimum return on investments commensurate with the proper levels of security, and endeavours to minimise the interest payable by the Council on its debt structure.

Economic Background and Analysis

7. The Council's short term investment and long term borrowing decisions have been affected by the following economic conditions:

   a. The second quarter of the financial year of 2009 saw:
      i. signs of recovery in the market, with some sectors showing growth
      ii. concerns remaining about the fragile state of any recovery with the impact of rising unemployment, therefore bank rate/investment rates expected to stay lower for longer
      iii. house prices rise at the fastest rate in over five years;
      iv. an extension of the Bank of England's quantitative easing programme although this had limited success in boosting credit or money supply growth;
      v. unemployment continue to rise and pay growth weaken further;
      vi. inflationary pressures in the economy ease further, but more slowly than had been expected;
      vii. conditions in financial markets improve further, and equity prices rally strongly;
      viii. sterling fall back, yielding much of the gains made in the first quarter;
      ix. other major economies exit the recession, including the US.

   b. At its meeting in August, the Monetary Policy Committee (MPC) increased the amount of asset purchases under the Bank's quantitative easing (QE) programme by £50bn to £175bn. Net lending to businesses increased in August for the first month since March, however, the household sector as a whole reduced unsecured debt in August. Banks are likely to remain reluctant to lend while conditions in the labour market are still deteriorating.

   c. The most upbeat news was from the housing market. The Nationwide house price index rose 3.8% in Q2, the largest quarterly rise since Q2 2004. House prices by this measure are now only 13.5% below their peak. And while the Halifax measure remained more downbeat, it too posted increases in the quarter. However, the rise in house prices appeared to be largely driven by the scarcity of homeowners putting their homes up for sale, suggesting that the rises may therefore only be temporary.

   d. Inflationary pressures in the economy eased further in the quarter, although at a slower rate than in the previous quarter, and more slowly than many expected. CPI inflation fell from 1.8% in June to 1.6% in August, largely as a result of falls in the annual rate of food and utility price inflation. However, core inflation rose from 1.6% in June to 1.8% in August – a higher rate than in other advanced economies. The rise most likely reflects the lagged impact of the pound's depreciation last year, and so should prove temporary.

e. Figure 1 shows the actual and projection of the base rate, which shows that the bank rate will remain at an historical low level potentially until 2011. Sector (the Council's treasury management advisors) have revised down their bank rate forecast in September 2009 from the position reported to Members at 31 July 2009 and now forecast the first bank rate increase to be in quarter ending September 2010. The forecast is based on moderate economic recovery and moderate MPC concerns about inflation looking 2 years ahead, which will lead to a rise in the base rate forecast. The other forecasts remain consistent to that reported previously and show that they believe growth will continue to be slower throughout 2011, therefore the rise in the base rate forecast is much less aggressive.

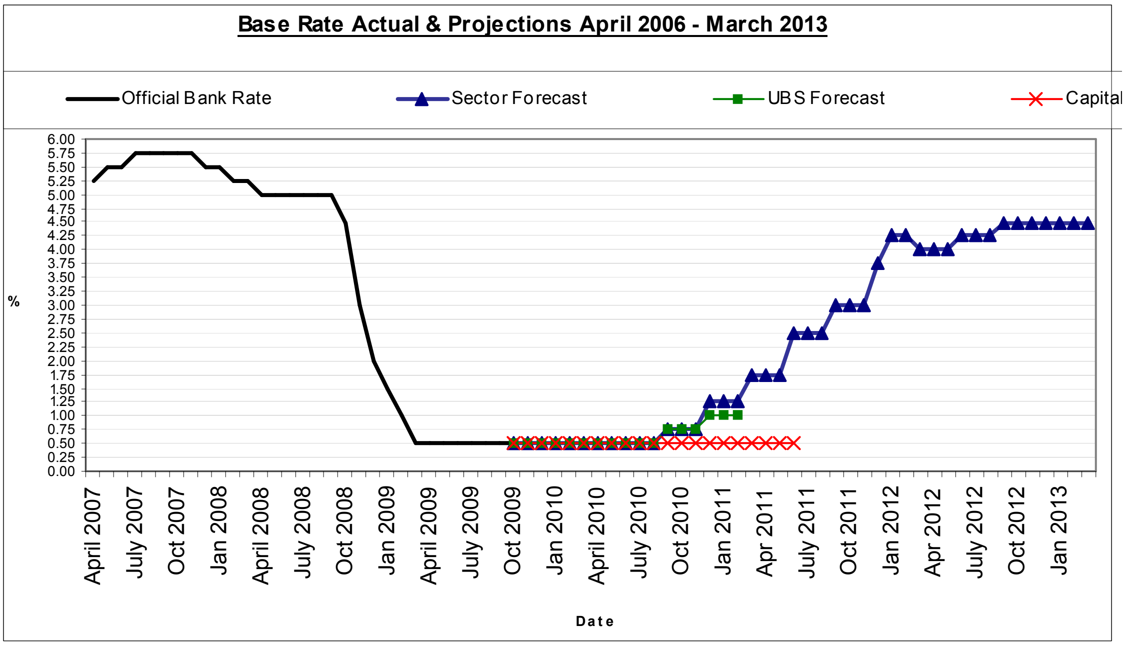

Figure 1 - Base Rate 2006 –2013 as at Sept 2009

e. Table 1 provides the Council's Treasury Advisers, Sector, forecast of the base rate and Public Works Loan Board (PWLB) rates as at 29 September 2009:

	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Bank rate	0.50%	0.50%	0.50%	0.75%	1.25%	1.75%	2.50%	3.00%	3.75%	4.00%	4.25%	4.50%	4.50%	4.50%
5yr PWLB rate	2.80%	2.90%	3.10%	3.20%	3.30%	3.55%	3.85%	4.15%	4.55%	4.60%	4.80%	4.80%	4.85%	4.85%
10yr PWLB rate	3.75%	3.80%	3.90%	4.00%	4.15%	4.30%	4.55%	4.75%	4.95%	5.00%	5.10%	5.15%	5.15%	5.15%
25yr PWLB rate	4.35%	4.45%	4.55%	4.60%	4.70%	4.90%	5.00%	5.00%	5.10%	5.20%	5.30%	5.30%	5.35%	5.35%
50yr PWLB rate	4.50%	4.55%	4.70%	4.75%	4.90%	5.00%	5.15%	5.15%	5.20%	5.25%	5.40%	5.40%	5.45%	5.45%

Table 1 – Sector's forecast interest rates as at 3 Sept 2009

f. With regard to long term borrowing, the Public Works Loan Board (PWLB) 45-50 year rate started the year at 4.57%. Rates have risen steadily up to a high of 4.85% at the beginning of June 09 with rates dropping back to the lowest level in 09/10 of 4.18% by mid October 09. The medium term PWLB 9-10 year rate started the year at 3.36%, saw its highest point at 4.15% at the end of July and by the end of September 09 the rate was 3.80%.

g. Long-term PWLB rates are forecast to steadily increase to reach 5.45% by the end of 2012 due to high gilt issuance, reversal of QE and investor concerns over inflation.

h. It should be noted that Sector have confirmed that there is a high level of uncertainties in all the above forecasts. This is due to the difficulties of forecasting the timing and amounts of QE reversal, fiscal contraction after the general election expected by May 2010, speed of recovery of banks' profitability and balance sheet positions, changes in the consumer saving ratio and rebalancing of the UK economy towards exports

i. Investment rates have fallen since the beginning of the financial year when the 1-year rate was at 2.15% to a level of 1.10% by the end of the September 09

j. A number of large UK banks keen to accept Local Authority investments continue to offer competitive rates on call accounts paying 0.25% to 0.3% above the Bank of England base rate as a minimum. In the first four months of 09/10 call accounts were paying rates equivalent or higher than could be achieved through 1 to 2 months fixed term money market investments. The next month showed call accounts paying higher rates than could be achieved for 3 months money and latterly in September call accounts are paying higher rates than 9-month market rates. The Council takes advantage of such accounts and currently actively operates 3 call accounts:
    i. Bank of Scotland instant access call account has been fixed at 0.25% above base during the period.
    ii. Alliance and Leicester call account has been constant at 0.30% above base rate.
    iii. Yorkshire Bank call account fixed at 0.30% above base rate.

   During 2008/09, 6 call accounts were operated but currently in the first half of 2009/10 they do not all add value to the investment portfolio.

Investment Policy

8. The Treasury Management Strategy Statement for 2009/10 was approved by Council on 21 February 2009. The Council's Annual Investment

Strategy, which is incorporated in the Strategy, outlines the Council's investment priorities as follows:

- Security of Capital
- Liquidity

9. The Council will also aim to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term, and only invest with highly credit rated financial institutions using the Sector suggested creditworthiness matrices, including Credit Default Swap (CDS) overlay information provided by Sector, the Council's Treasury Management advisors.

10. Investments held at 30 September 2009 in accordance with Sector's Creditworthiness matrices, and changes to Fitch and Moody's credit ratings remained within the Council's approved credit criteria limits contained in the Annual Investment Strategy and the limits were not breached during the first 6 months of 2009/10.

Short Term Investments

11. Investment rates available in the market remain at an historical low point. The average level of funds available for investment purposes in the first six months of 2009/10 was £49.527m, a fall of £2m from Quarter 1. These funds are available on a temporary basis, and the level of funds available is largely dependent on the timing of the Council's cash flow as a result of precept payments, receipt of grants and progress on the Capital Programme. The average balance is lower than in previous years due to the timing of grants received in advance of need being shorter. The authority holds some core cash balances for investment purposes, i.e. funds available for a year or more.

12. Treasury Management investment activity during the first six months earned interest £653k, equivalent to a 2.34% rate of return. This is 1.89% better than the average 7 day London Inter-Bank Deposit rate (LIBID) of 0.45% and 1.84% higher than the average base rate for the period of 0.50%. The high rate of return on investment activity compared to the average LIBID rate and base rate for the period is due to (a) locking into higher rates in 2008/09 for periods up to a year which had a positive affect on the average interest rate in 09/10 and (b) the treasury team continuing to monitor the market and taking advantage of longer term rates out to a year when they become available. The level of activity compared to the treasury management indicators above is positive, however the market interest rates in the first 6 months of the year have been lower than anticipated.

13. Taking into account the direct cost of dealing, the in-house team is forecast to achieve a net trading surplus in 2009/10 of £918k. This will be equivalent to a return of 1.85%, which is 1.35% above the estimated average rate to be paid by the bank on credit balances held in the

Council's main bank account. The bottom line added by the Council's money market trading activities taking off the direct cost of dealing is estimated at £670 for 2009/10.

14. The Council has made 9 investments via the money market brokers during the first 6 months of 2009/10. Of these 4 have been for a month or less, in accordance with the Treasury Management Strategy keeping investments short. 5 have been invested for a period of greater than one month.

15. More recently a large proportion of investments have been placed in call accounts where funds are secure and the rate of interest earned at 0.80% is more favourable than rates available on the market up to 9 months. This is shown in Figure 2 below at 15/09/09. Call accounts also have the benefit that these funds can be liquidated at any time so advantage can be taken of longer-term favourable rates when they arise. Investments are made in accordance with the security of the Council funds, the cash flow position (Liquidity) and consideration to most favourable investment rates available.

16. Figure 2 shows the investments for periods over 1 month in duration in comparison to the range of rates (between 1 month and 1 year) being offered on the money markets at the time investments were made. It shows the investment rates obtained are in line with the interest rates which are available when security of funds are of prime importance.

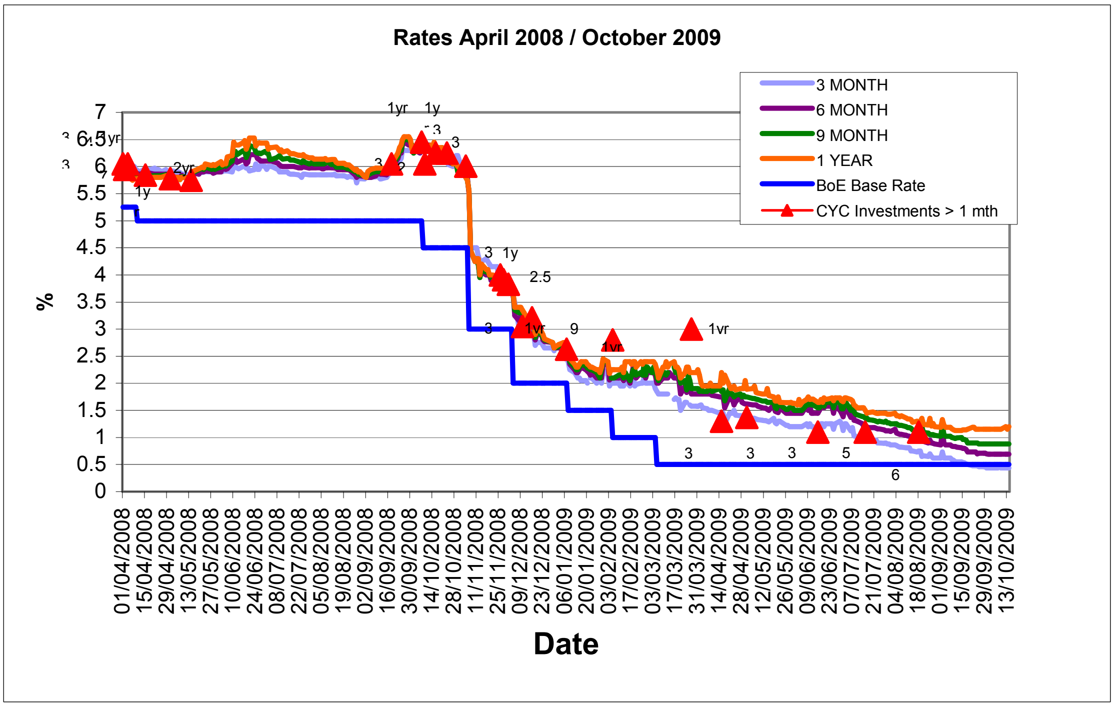

Figure 2 CYC Investments vs Money Market Rates

Long Term Borrowing

17. The Council undertakes long term borrowing in accordance with the investment requirements of the capital programme, and all borrowing is therefore secured against its asset base. The majority of Council borrowing is funded by the Government through the Revenue Support Grant (RSG), which provides the Council with revenue funding to allow it to meet the interest and repayment costs of borrowing. The introduction of the Prudential Code in April 2004 has given the Council the flexibility to borrow without Government support. Under the Code Councils are free to borrow up to a level that is deemed prudent, affordable and sustainable and within their prudential indicator limits.

18. The Councils long-term borrowing started the year at a level of £102.1m. The level of borrowing taken by the Council is determined by the Capital Finance Requirement, (the Councils underlying need to borrow for capital expenditure purposes). The Capital Financing Requirement for 2009/10 is £5m. One loan of £4m was duly repaid in May in line with its maturity date. New Borrowing has been taken during the first 6 months as follows:
    - £3m PWLB loan at 3.83% 10 years on 10 August 09
    - £3m PWLB loan at 3.59% 10 years on 8 October 2009
    - £3m PWLB loan at 3.91% 15 years on 13 October 2009

19. The loans taken in 2009/10 have been of fixed term duration and target periods that offer the best rates available. The period of 10 to 15 years has been identified as providing the best opportunity (a) for value for money as it is difficult to predict how the market will continue to move long term in the current environment and (b) the potential to reschedule the loan if required in future years. Forecasts currently show that PWLB rates in all periods will rise in the next 2 years; this is illustrated in Table 1.

20. In addition, the Council can borrow in advance of need in line with its future borrowing requirements in accordance with the Capital Financing Requirement. The Administrative Accommodation project will substantially increase the Council's need to borrow over the next 3 years and therefore the markets will be closely monitored to ensure that advantage is taken of favourable rates in 09/10 and the increased borrowing requirement is not as dependant on only interest rates over a 3 year period.

21. The Council's borrowing strategy is to borrow from the PWLB when rates are low and hold off from taking new borrowing when rates are high following advice taken from the Councils contracted treasury management advisors (Sector Treasury Services) subject to cash flow constraints. Long term borrowing rates started the year at a level of 4.57% and have since fluctuated between 4.18% and 4.85%. Figure 3 shows the PWLB rates since April 2006 and details when new borrowing has taken place.

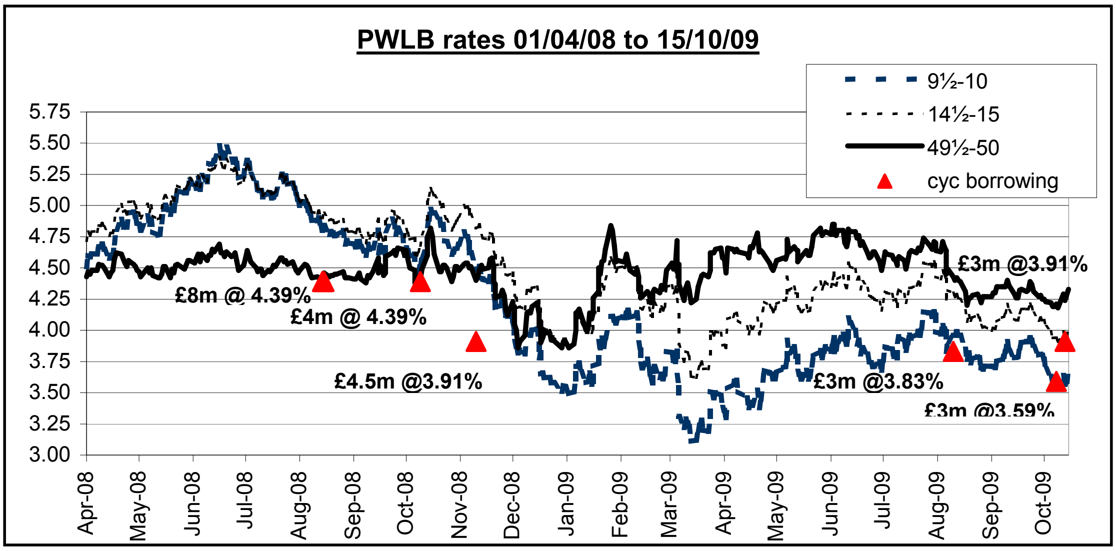

Figure 3 – PWLB rates vs CYC Borrowing Levels

22. Figure 4 illustrates the 2009/10 maturity profile of the Council's debt portfolio updated to reflect the borrowing this year. The borrowing portfolio totals £107.1m and the maturity profile shows that there is no large concentration of loan maturity, thereby spreading the interest rate risk dependency in any one year.

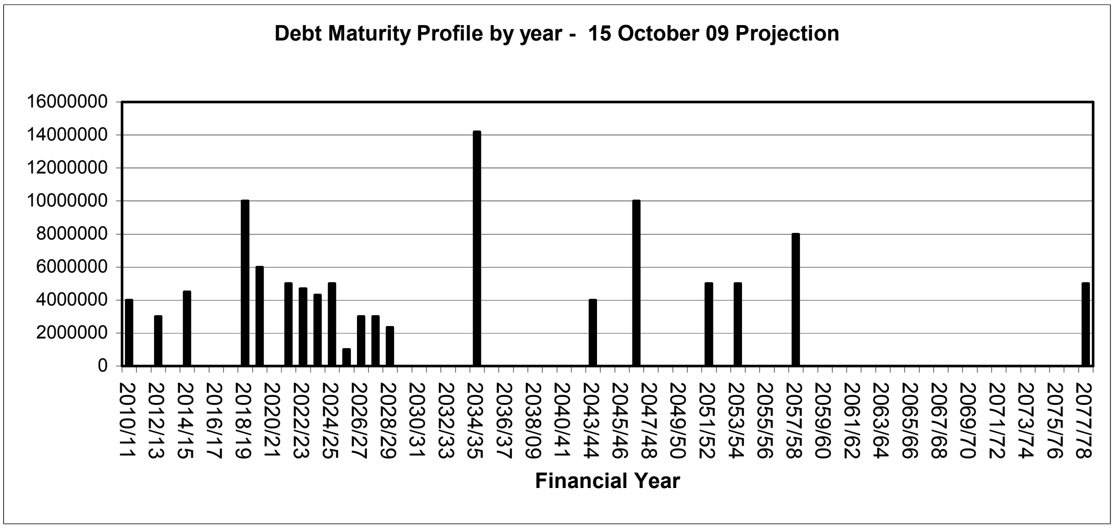

Figure 4 – Debt Maturity Profile 09/10

Venture Fund

23. The Venture Fund is used to provide short to medium term investment for internal projects which provide new revenue streams or generate budget savings and contribute to operational benefits of policy objectives. The projected movements on the Venture Fund for the year are shown in table 2 below.

	£'000
Balance at 1st April 2009	**2,275**
New Loan Advances	(750)

Loan Repayments	678
Net Interest Received	18
Balance at 31st March 2010	**2,221**

Table 2 – Projected Venture Fund Movement 2009/10

24. The position of the Venture Fund has not changed since that reported at Monitor 1. New Loan Advances of £750k include £650k for the easy programme which reflects funding required for internal resources associated with the transformation programme – More for York - work and £100k for the street lighting capital scheme approved by Council on 21 February 2009. The easy programme loan is a prudent estimate of the amount, which will potentially be required by year-end. 7 schemes contribute to loan repayments of which five will be completed at the end of 2009/10.

Treasury Management Budget

25. Treasury Management activity had a Corporate Budget approved at Council on 21 February 2009 of £7,727k. In August 2009, the current approved budget was £8,557k. The projected outturn is £9,086k resulting in an estimated under recovery of income of £529k. Table 3 details the individual components that make up this overspend.

	(Under)/Over Spend £000
Increase in financing expenditure (interest paid)	8
Provision to repay debt	0
Decrease in interest receivable	521
Total Overspend	**529**

Table 3 – Treasury Management Budget 2008/09

26. The expected Treasury Management budget under recovery of income remains at £529k as reported at Monitor 1, however the breakdown of the under recovery has changed and is weighted towards an under recovery of income from interest received.

    a. The increase in interest paid is only slightly above that which was budgeted compared to the larger increase in interest paid that was expected at Monitor 1 of £150k. The increase is only marginally above that which was budgeted due to the volatility of the market, the timing of loans taken and the inclusion of the reduction in interest to be paid on previous debt rescheduling.

    b. The decrease in interest receivable is due to the continued fall in market interest rates available for investment with the 1-year rate starting the year at 2.15% and continuing to fall to 1.15%. There are lower cash balances than originally anticipated, therefore the majority of cash is being invested in line with cash flow requirements and an increasing proportion of the treasury management interest earned budget is to be paid to departments on their surplus funds.

27. There is little action that can be taken to mitigate the under recovery of income during 2009/10 due to the current economic environment. It is expected that growth will be slow until 2010/11, resulting in continued lower market interest rates being available for investments. This is evidenced by the increased quantitative easing announced by the Bank of England to a further £175bn. Lower interest rates on investments will therefore be earned for the foreseeable future. This is compounded by the prudent Council's approved credit criteria limits set for the security of funds, which reduces the favourable interest rates available for investment.

28. In the longer term, the economy is forecast to recover, with interest rates becoming more favourable for investment purposes. The market environment will improve and cash balances should grow with the increase of capital receipts. The borrowing market is continually monitored and in the future there maybe the opportunity to restructure the debt portfolio to make savings overall. It should be noted that this is not an ongoing problem but one caused by the current economic market environment.

Prudential Indicators Update

29. It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits". Council's approved Prudential Indicators (affordability limits) are outlined in the approved Treasury Management Strategy. Prudential Indicators are attached at Annex A. Prudential Indicators were not breached during the first 6 months of 2009/10.

Human Resources Implications

30. There are no HR implications as a result of this report.

Equalities

31. There are no equalities implications as a result of this report.

Legal Implications

32. Treasury Management activities have to conform to the Local Government Act 2003, which specifies that the Council is required to adopt the CIPFA Prudential Code and work to its Treasury Management Policy and Treasury Management Practices. As a result the Council can only invest and borrow from approved institutions as set out in sections 1 and 12 of the Act.

Crime and Disorder Implications

33. There are no crime and disorder implications as a result of this report.

Information Technology Implications

34. There are no IT implications as a result of this report.

Property Implications

35. There are no property implications as a result of this report.

Risk Management

36. The treasury management function is a high-risk area because of the level of large money transactions that take place. As a result of this there are procedures as set out in the Treasury Management Practices statement that aim to reduce the risk associated with high volume high value transactions.

Recommendations

37. Members are requested to:
    - Note the performance of the treasury management activity;
    - Note the general fund venture fund repayment holiday to assist in corporate budget savings.
    - Note the projected overspend of the treasury management budget of £529k.

Reason – to ensure the continued performance of the Council's Treasury Management function.

Contact Details

Author:
Louise Branford-White
Technical Finance Manager
Corporate Finance
Tel No. 551187

Ross Brown
Principal Corporate Accountant
Corporate Finance
Tel No. 551207

Chief Officer Responsible for the report:
Ian Floyd
Director of Resources

Keith Best
Assistant Director of Resources (Finance)

Report Approved ☐ Date 25/11/08

Wards Affected: ☐ None

Specialist Implication Officers:

None

For further information please contact the author of the report

Background Papers

Cash-flow Model 09/10, Investment Register 09/10, PWLB Debt Register, Capital Financing Requirement 09/10, Venture Fund 09/10, Statistics 09/10.

Annexes

Annex A – Prudential Indicators