CITY OF YORK COUNCIL

Executive

20 July 2010

Report of the Director of Customer & Business Support Services

Treasury Management Annual Report & Review of Prudential Indicators

Summary

1. This reports updates the Executive on treasury management performance for 2009/10 compared against the budget and treasury management strategy taken to full Council on 26th February 2009. The report summarises the economic environment over the 2009/10 financial year and reviews treasury management performance in the following areas:

    - Economic Background
    - Long term Borrowing,
    - Debt Restructure,
    - Short term Investments,
    - Investment credit criteria policy,
    - The Venture Fund,
    - Treasury Management Outturn and
    - The Prudential Indicators.

Background

Treasury Management Position as at 31 March 2010

2. The Council's debt and investment position at the beginning and the end of the year was as follows:

	31-Mar-10	Rate/ Return	31-Mar-09	Rate/ Return
	£M		£M	
Fixed Rate Funding:				
-PWLB	101.1		87.1	
- Market	15.0		15.0	
Total Debt	**116.1**	**4.52%**	**102.1**	**4.57%**
Total Investments	**25.9**	**2.20%**	**30.9**	**5.35%**

Table 1 – Position of the treasury management portfolio

3. The table shows that the council's borrowing continues to increase in line with the demands of the capital programme, whilst that average interest rate declines. The investment portfolio has fallen during 2009/10, as interest rates are less favourable for investment with a fall of return in the year of 3.15%.

Economic Background

4. The performance of the council's treasury management function is an outcome of the long-term borrowing and short-term investment decisions that were affected by the following economic conditions during the 2009/10 financial year.

   a. The 2009/10 financial year started 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 anxiety as to how or when recovery would take place.

   b. During 2009/10 the Monetary Policy Committee (MPC) was focused on helping the economy to turn around from plunging into the deepest and longest recession the UK economy had experienced for many years.

   c. Despite keeping Bank Rate at an unprecedented historical low of 0.5% all year, the MPC also had to resort to extreme measures in terms of pumping liquidity into the economy through quantitative easing by purchasing £200bn gilts and corporate bonds. This had the effect of boosting prices for gilts and corporate bonds at certain times of the year and therefore bringing down yields, so also reducing borrowing costs for both the corporate and public sector on a volatile basis.

   c. It was notable that the increase in money supply in the economy generated by this programme brought the credit crunch induced spread between Bank Rate and 3 month LIBID (investment rate that depositors could earn) down from 0.95% at the beginning of the financial year to zero during August.

   d. The dominant focus in 2009/10 was on quarterly GDP growth figures. The recession bottomed out in quarter 1 of 2009. There was then major disappointment that the end of the recession failed to materialise in quarter 3 2009 but the fourth quarter of 2009 did then see economic growth return at +0.4%.

   e. Inflation has not been a major concern of the MPC as it fell back below the 2% target level from June to November. However, it did spike upwards to reach 3.5% on the back of the unwinding of the temporary cut in VAT to 15% on 1 January 2010. This was not seen as a cause for alarm as this spike was expected to fall out of the inflation index and inflation was forecast by the Bank of England to fall back under target by the end of 2010.

f. The equity market ended in buoyant mode with shares being at their highest level for nearly two years. The reverse side of this coin though was that gilt prices had fallen and long term yields (and so PWLB long term borrowing rates) were getting near to their peak for the year. The bond markets ended the year with chronic fears about a possible Greek government debt default and commentators were remarking that both Greece and the UK were running similar size annual deficits as a percentage of GDP (expected to be over 12%). However, the UK was in a much stronger position than Greece e.g. due to its much lower level of total debt. However, there were frequent comments from credit rating agencies around a possible threat that the UK government could lose its AAA credit rating if after the general election there was not a credible plan for how the promised reductions in the annual budget deficit would actually be achieved.

g. The Chancellors emergency budget of 22 June 2010 has shown the cuts that the Coalition Government is prepared to make and further information is awaited as part of the Spending Review expected in October 2010.

5. Figure 1 shows the base rate movements since 2004/05 with predictions from economists for 2010/11 to December 2012. When the treasury management strategy was approved for 2009/10 in February 2009 Sector Treasury Services – the Council's treasury management advisers – predicted that the base rate would start to recover in quarter 1 of 2010, this has now been revised to Quarter 1 of 2011. These are unprecedented times and it is yet to be seen the effect that the new coalition government will have on the market and when the economy will slowly start to recover.

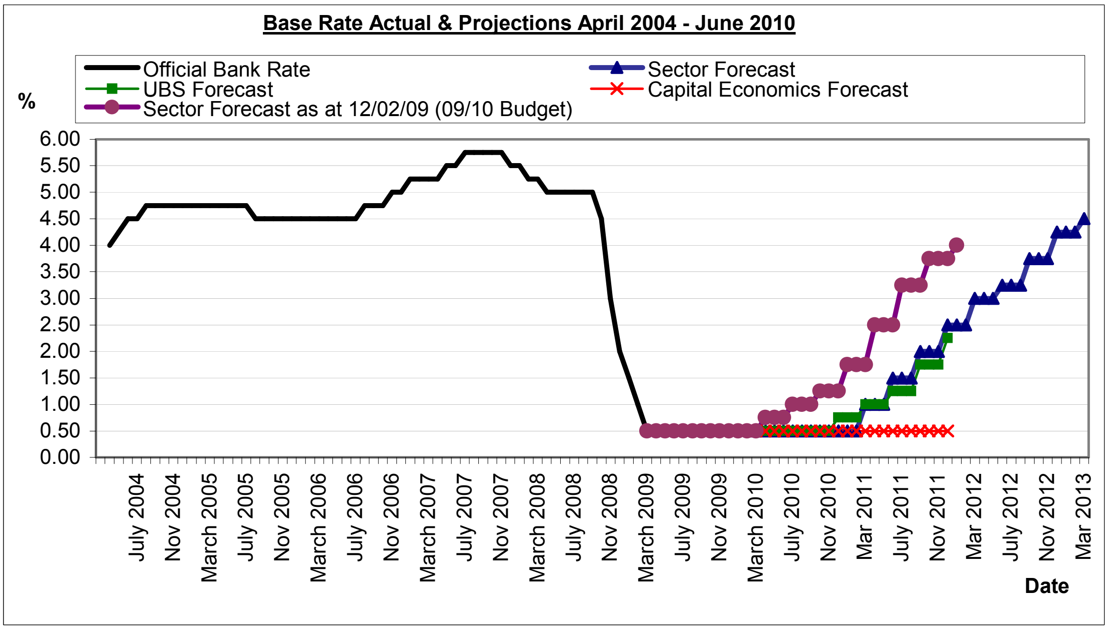

Figure 1 - Base Rates 2004- 2012 as at April 10

Long term Borrowing

6. Under Statute, the council is permitted to borrow to fund capital expenditure. This funding is linked to the delivery of capital investment programmes such as the Local Transport Plan and Schools' Modernisation programmes. It should be noted that when borrowing is undertaken it is not taken for any specific scheme or project but rather to fund the council's capital financing requirement as a whole.

7. Council borrowing is either supported 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; or borrowing is unsupported where by under the Prudential Code, introduced in April 2004, the Council has increased flexibility and is allowed to borrow up to a level that is deemed prudent, affordable and sustainable. Any borrowing that is undertaken using the prudential code framework is not supported by government and has to be funded by the council revenue budgets. All borrowing is at a level within the prudential indicator limits, set on a 5 year basis in the treasury management strategy by full Council annually.

8. The flexibility of borrowing under the prudential code allows the council to borrow in advance of need. The level of borrowing the council requires is determined by the Capital Financing Requirement (CFR) which is the cumulative borrowing that the council undertakes to fund capital expenditure and identifies the council's underlying need to borrow. The CFR is forecast

over the next 5 years and shows that the council will have an increasing need to borrow due to the requirement of the Administrative Accommodation project. This allows for the proactive treasury management decision to borrow in advance of need, to take advantage over favourable interest rates when they arise, not to have to borrow in one specific year and therefore spreads the interest rate risk.

9. The level of borrowing at 31 March 2010 was £116.1m, slightly lower than the CFR £123.8m. This position has changed since 2008/09 when borrowing was £102.1m, slightly above the CFR of £98.7m. This is as a result of proactive treasury management decisions during 2009/10 to take long term borrowing when rates were deemed favourable, but also be mindful that when borrowing is taken the rates exceed the rates of interest that could earned on the investment portfolio. Therefore, it was also favourable to the treasury management overall budget to reduce the investment portfolio rather than continue to take new borrowing. In addition consideration is also given to the long term view of the treasury management portfolio and to weigh this against short term gain to the revenue budget.

10. Interest rates are forecast to rise across all periods in the coming years. In accordance with Sector Treasury Services – the council's treasury management advisers – forecast of 19 May 2010, 25 year + PWLB rates are predicted to be above 5% from December 2011, but there are still opportunities to take shorter borrowing around 4.5% in 5 and 10 year periods in 10/11; potentially due to volatility in the market longer term rates at around 4.5% may also be available. Consideration will still be given to borrowing in the 25 and 50 year periods to match the life of the council capital schemes for which borrowing is taking place. PWLB interest rates just below 5% are still good value when looking at levels over the past decades.

11. The council's borrowing strategy set for 2009/10 at full Council on 26 February 2009 followed advice from the council's treasury management advisors –Sector Treasury Services - to borrow primarily from the PWLB when interest rates are advantageous and hold back on borrowing when rates are relatively high. The Council set a trigger point for taking long term borrowing of 3.95% during 2009/10. Average PWLB maturity loans for 2009-10 were:

I year	0.90%
9.5 - 10 year	3.93%
24.5 - 25 year	4.49%
49.5 - 50 year	4.51%

12. Figure 2 illustrates the PWLB rates for 2009/10 including the loans borrowed by the council. It is interesting to note the PWLB rates remain

significantly higher compared to the base rate. The borrowing taken by the council was below the trigger point of 3.95%, ranging between 1 year and 10 years. This was the best value achievable during the year.

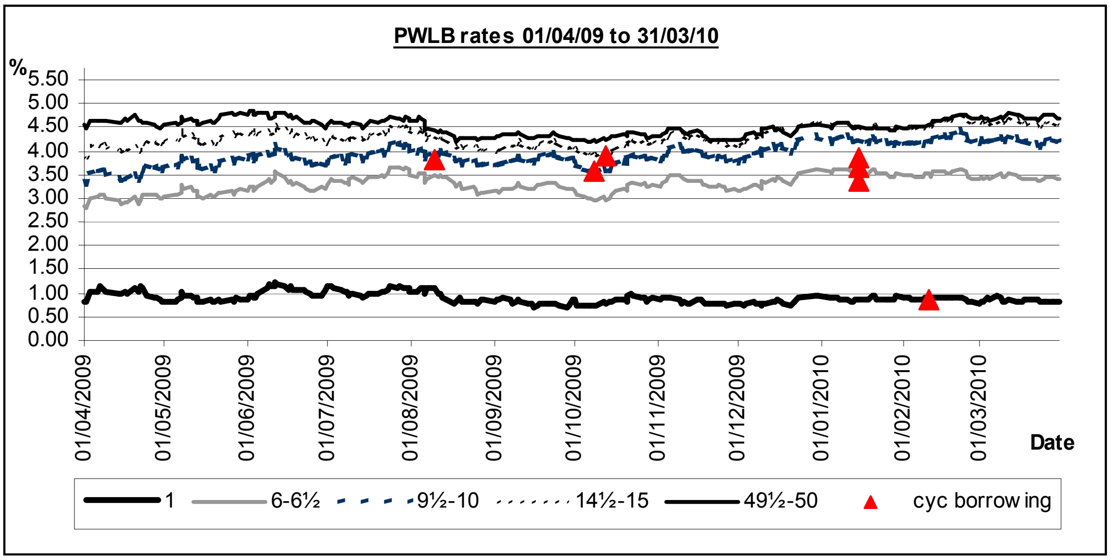

Figure 2 - PWLB rates vs. Bank of England vs. CYC borrowing levels

13. In addition to the long term borrowing described above, the council did not reschedule any PWLB debt in 2009/10 due to the changes to the PWLB rates which were made by the Government in November 2007. The change has resulted in only very marginal savings if restructuring occurred. Rates are being monitored and when there is greater variation between rates then higher savings could be achievable. Further details are supplied in the Debt Rescheduling section below at paragraphs 22-24 with regards to a reminder of the change in the regulations and what it has meant during 2009/10.

14. The councils long-term borrowing started the year at £102.4m. Table 2 shows the movement in debt during the year, the interest rates obtained on new borrowing, the average rate of the portfolio and the year of maturity.

	Date	**£**	**Prevailing Base Rate**	**Weighted %**	**Year of Maturity**
Total Debts at 1/4/09		**102,364,956**	**0.50%**	**4.57%**	
Less Loans Repaid	05/05/09	4,000,000		3.80%	2009/10
Plus New Loans	10/08/09	3,000,000		3.83%	2019/20
	08/10/09	3,000,000		3.59%	2019/20
	13/10/09	3,000,000		3.91%	2024/25

	05/11/09	2,000,000		3.36%	2015/16
	05/11/09	2,000,000		3.64%	2016/17
	05/11/09	2,000,000		3.87%	2017/18
	10/02/10	3,000,000		0.85%	2010/11
Total Debts at 31/03/10		**116,064,956**	**0.50%**	**4.52%**	

Table 2 - Movement In Long Term Borrowing 2009/10

15. All of the new borrowing decisions were taken in light of the maturity structure of the Council's current long term borrowing. Prudential indicator 9 sets the permitted maturity structure of borrowing, as detailed in Figure 3 and attached at Annex A, along with all the Prudential Indicators approved by full Council in the treasury management strategy report 26 February 2009. The borrowing of long duration loans reflects the Councils underlying need to borrow for capital purposes and is forecast to rise steadily year on year for the foreseeable future in line with the capital programme.

16. Figure 3 illustrates the 2008/09, 2009/10 and 2010/11 maturity profile of the council's outstanding loans. The profile moving forward in 2010/11 highlights that the debt portfolio is spread over different maturity periods, which diversifies the risk of borrowing in any 1 year. The greatest level of debt to mature is between 6 to 10 years. It is unlikely that borrowing will occur in this range in the next year to ensure the risk on maturity is spread.

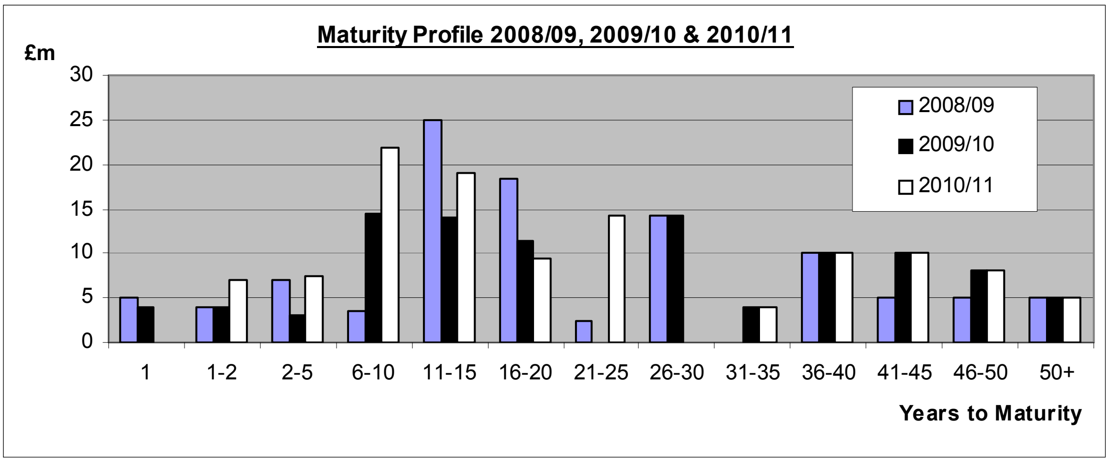

Figure 3 - Debt Maturity Profile 07/08, 08/09 & 2009/10

17. As a result of the borrowing undertaken in-year, the average rate of interest on the council's long term borrowing has fallen from 4.57% in 2008/09 to 4.52% by the end of 2009/10. This is 0.051% lower than the latest available average long term borrowing rate (source CIPFA Statistics) for unitary authorities of 4.92% for 08/09. Although the councils average rate is lower

than other similar authorities, were it not for the Club Loan of £10m at a rate of 7.155%, which the council is unable to restructure, the councils consolidates rate of interest could be as a low as 4.27% (assuming the £10m Club loan where to be replaced at a level of 4.5%). Figure 4 shows the council's long term borrowing compared to the national average and other unitary authorities.

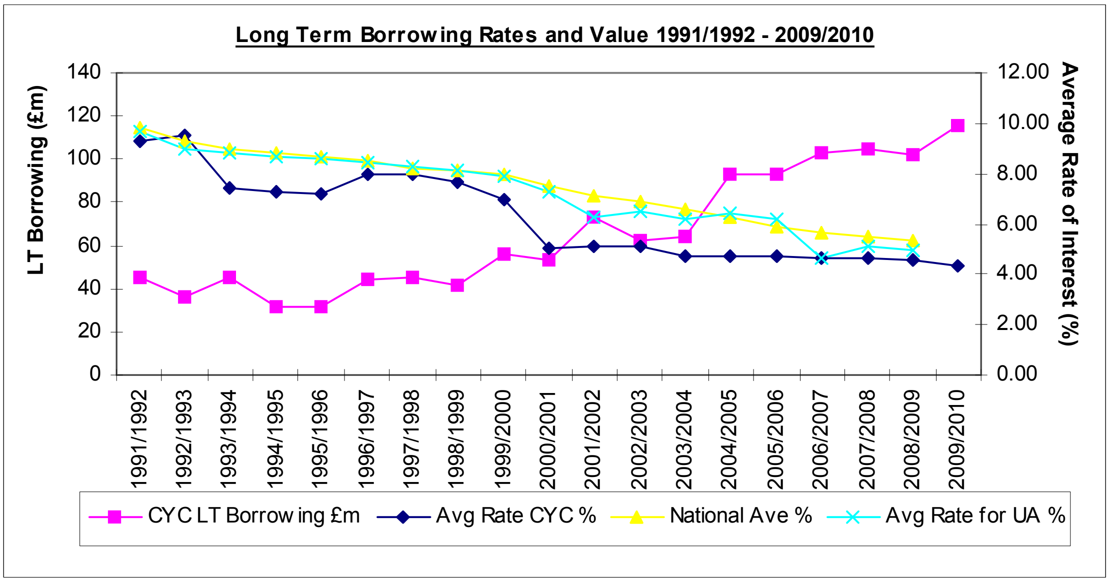

Figure 4 - CYC borrowing vs National Average vs Unitary Authority

Debt Restructure

18. The treasury management team monitor the markets daily for rates that would allow favourable restructures. However, during the year no debt restructuring occurred due to the change in the publics Works Loan Boards (PWLB) regulations back in November 2007.

19. On 1st November 2007 the PWLB imposed two rates for each period, one for new borrowing and a new, significantly lower rate for early repayment of debt. The differential between the two rates ranged from 26bp (basis points) in the shorter dated maturities to over 40bp in the longer ones. They also introduced daily movements of 1bp instead of 5 bps and rates in half year periods throughout the maturity range (previously had been mainly in 5 year bands). These changes effectively prevented the Council from restructuring the portfolio into new PWLB borrowing.

20. These changes have effectively prevented the Council from restructuring the portfolio into new PWLB borrowing. In 2009/10, there was also limited borrowing available from the market due to current economic conditions, therefore restructuring has not been possible into market loans. Going

forwards into 2010/11, market loans are re entering the market, so rescheduling loan opportunities may become available.

Short Term Investments

21. At the start of 2009-10, investment rates were enhanced by a substantial credit crunch induced margin. This has assisted the performance of the rate of return on investments in the early part of the year due to longer term investments having been made during 2008/09. However, the Bank of England's quantitative easing operations had the desired effect of improving the supply of credit in the economy and so these margins were eliminated by half way through the year. Consequently, investment rates fell markedly during the first half of the year

22. The council manages all its surplus cash investments in-house and invests with the institutions listed in the council's approved lending list. The council invests for a range of periods from overnight to 364days, dependent on the council's cash flows, its interest rate view and the interest rates on offer. The council also invests longer term when rates are considered favourable and core cash balances are available, although this did not occur in 2009/10. During the year all investments were made in full compliance with this Council's treasury management policies and practices.

23. The Annual investment strategy set for 2009/10 noted that the base rate was at 0.5% and set to stay at historically low levels throughout 2009/10. The Council's in-house funds are mainly cash flow derived and therefore investments were made in periods where most value was seen to be added in the short term. Call accounts (deposit accounts available directly with certain banks e.g. Bank of Scotland, Yorkshire Bank, Santander-Alliance & Leicester and Santander – Abbey National) were utilised as they offered both instant access and better returns than money market interest rates for periods up to six months. Thus the nature of the surplus funds has changed in the last year with investment being short term and relatively liquid.

24. There was limited opportunity to invest funds longer term; it was better to keep investments short so that when interest rates start to rise, advantage can be taken of these more favourable rates.

25. With the environment for bank investments expecting to change later in 2010, with banks being steered away from short end funding by regulators, the attractiveness of call account rates is likely to decline. The market will be monitored and the treasury team will react to subtle changes in market rates in due course, which is likely to require the investment periods for the surplus funds to be extended to longer periods once more.

26. During March 2010, the Council opened a money market fund which is an alternative method of investment than placing funds on deposit directly with financial institutions. The money market fund is an investment vehicle controlled by the Financial Services Authority, given the highest credit rating available AAA buy the Credit rating agency, allows instant access to funds, offers a slightly higher rate that funds on deposits and is diversified as holds many different financial institutions within the money market fund. The Council is continuing to monitor the market to take advantage of alternative investment vehicles that allows security of capital but also allows increase investment returns.

27. Figure 5 illustrates the Investment interest rates available for 2009/10 including the rate of return on investments achieved by the council during 2009/10.

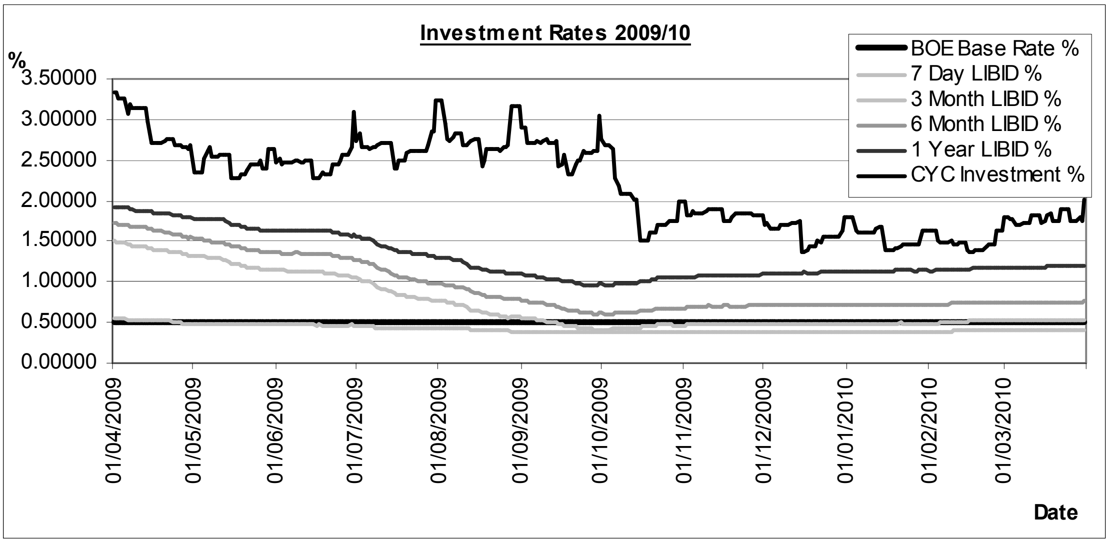

Figure 5 – Investment rates vs. Rate of Return on CYC Investments

28. Interest earned during the year on cash balances totalled £1.038m (£3.160m in 2008/09). The Council's average balance available for investment in 2008/09 has decreased from £58.9m in 2008/09 to £47.2m in 2009/10. This decrease in average cash balances mainly resulted from the timing of borrowing taken during the year and borrowing slightly less than required to match capital expenditure. This was due to borrowing rates and therefore interest payments being higher than could be earned on investments and the interest received. Therefore part of the council's surplus fund were used to fund the Capital Programme, thereby decreasing investment balances.

29. The average rate of interest earned on investments in 2009/10 was 2.20% (5.35% in 08/09). This was 1.78% higher in 2009/10 (1.66% in 2008/09) than the average 7 day London Inter-Bank Bid Rate (LIBID) (the standard

benchmark for short-term cash management) of 0.42% (3.69% in 2008/09). The average interest rate earned is higher than the benchmark due to longer term investments made last year at higher rates and maturing in 2009/10.

30. During the year, the council made 134 investments totalling £349m compared with 134 totalling £368m in 2008/09. Te average maturity length was 92 days in 2009/10 compared to 228 days in 2008/09. This highlights the difficulties in the markets during 2009/10 as the Council was limited with whom it could invest, the length of time was limited and therefore it was increasingly difficult to obtain favourable rates. This occurred in line with the Investment strategy that the security of capital is of prime importance.

31. The treasury team continually monitor the performance of the money market brokers. The council operates on the money markets with four brokerage organisations - ICAP, Sterling International Brokers Tradition and Tullett Prebon. It is intended to retain these four brokerage organisations going forwards.

Investment credit criteria policy review

32. The default of the Icelandic banks in October 2008 led to a review of the Council’s credit policy, to ensure that the credit risk exposure was at an acceptable level. This review has been monitored throughout 2009/10 to continue to ensure that the security of capital is of prime importance, whilst balancing this with return to be achieved. No institutions in which investments were made during the year had any difficulty in repaying investments and interest in full.

33. All surplus cash balances in 2009/10 were invested with authorised counterparties in accordance with the council’s Treasury Policy Statement. Counterparties are authorised for use based on their credit ratings. The council’s credit rating criteria is set using a matrix provided by our Treasury Management Advisors – Sector Treasury Services. The matrix is based on credit ratings provided by agencies Fitch, Standard and Poors and Moody's. This determines both time and financial limits in order to spread counterparty (credit) risk when investing money with approved counterparties.

34. The higher the credit rating assigned to a counterparty, the more secure the counterparty is. The Council has investment limits of £15m for periods up to 1 year with high credit rated counterparties and for those with a lower credit ratings an amount of £8m and up to 3months.

35. During 2009/10, it was found that the number of authorised counter parties that the council could invest with has been massively reduced due to the

higher credit rating levels set to ensure the security of council's funds. Even with the inclusion of nationalised banks on the council's credit rating criteria policy, the placing of surplus funds has been tight.

36. During 2009/10 alternative investment instruments have been reviewed to diversify the portfolio and a money market fund as described above was opened during March 2010. The treasury team along with the council's treasury management advisers will continue to monitor alternative new investment instruments e.g. treasury bills, euro sterling bonds.

Venture Fund

37. The Venture Fund is used to provide short to medium term investment for internal projects that provide a robust new revenue stream or recognisable budget reductions and contribute to operational benefits or policy objectives. The movements on the Venture Fund in the year are shown in table 3.

	£'000
Balance at 1 April 2008	**2,275**
New Loan Advances	(758)
Loan Repayments Received	678
Net Interest Received	24
Balance at 31 March 2009	**2,219**

Table 3 - Venture Fund Movement 2009/10

38. New loan advances were made in 2009/10 for Easy at York Programme £627k approved by Executive in the Budget in 2009, Peckitt Street defences £31k approved in Capital Monitor 2 November 2009 and £100k for Street Lighting approved in the Capital programme Budget February 2009. 6 existing schemes repaid their annual instalments totalling £678k, therefore the balance of the Venture Fund at the end of 09/10 was £2,219k.

39. In future, funds committed to be draw down from the Venture Fund are £500k for the Treasury Management Budget in 10/11 due to the economic downturn; this is projected to be repaid in 12/13 and also £2,217k for the Administrative Accommodation project. At the Executive on 20 July 2010 in a separate report, the Administrative Accommodation project is requesting increased use of the Venture Fund of £435k to £2,217k to finance the Early Years Deficit of that scheme. This is to fund the initial finance costs of borrowing in the early years of the project prior to the revenue budgets coming available from previously leased establishments.

40. Over a five year forecast to 2014/15 the balance of the Venture Fund will be £825km. The Venture Fund is forecast to have sufficient funds to meet the current requirements described in paragraph 48 and there is a commitment

from the Administrative Accommodation project forecast revenue streams to repay the Venture Fund commencing in 2014/15.

Financial Implications - Budget Outturn

41. Treasury Management activity is contained within the Corporate Budget, which was approved by Council on 26 February 2009 at £7,727k for 2009/10. Since the budget was set there have been a number of changes approved by the Executive which has resulted in a revised budget of £8,866k.

42. The outturn was £8,900k, which resulted in an overspend of £34k. At monitor 3 it was projected that there would be an overspend £429k, the improvement was due to interest paid on borrowing has been lower than anticipated due to timings of borrowing taken and slightly lower interst rates; also interest received on both internal and external investments was slightly higher than expected.

43. The main report explains the underlying reasons for the fluctuations in the treasury management budget during the year.

44. In 2009/10, the Council did not receive a dividend from the Bank of Credit and Commerce International (BCCI). The total recovered losses to date stands at £1,318k, which is 94% of the investments made with the BCCI in 1990 when it collapsed. The amount recovered is now £452k more than was written off by the council.

Review of the Prudential Indicators

45. In accordance with the Prudential Code, the Prudential Indicators set by full Council on 26th February 2009 must be reviewed. Full detail on the indicators are given in Annex A.

Consultation

46. The majority of this report is for information purposes and reports on the performance of the treasury management function. Members through the budget process set the level of budget and expected performance of the Councils treasury management function.

Options/Analysis

47. In accordance with the Local Government Act 2003, it is a requirement under the CIPFA Prudential code and the CIPFA Treasury Management in Local Authorities that the Executive of the council receives an annual treasury management review report of the previous year –2009/10- by 30 September the following year – 30 September 2010. It is also a

requirement that the Council delegates the role of scrutiny of treasury management strategy and policies to a specified named body which in this Council is the Audit & Governance Committee. This annual treasury management report is scheduled at Audit & Governance Committee on 28 July 2010.

48. The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009 was adopted by this council on 25 February 2010 and fully complies with its requirements. The revised "code" became available during 2009/10 as CIPFA's response to the Audit Commission's review of Treasury Management in Local Authorities "Risk and Return" in light of the Icelandic banking collapse.

Corporate Priorities

49. The council will meet its Corporate Strategy objective of "Effective Organisation" to achieve high standards by successfully and proactively managing its treasury activities. Effective treasury management is concerned with the management of the council's cash flows, it's banking, money market and capital transactions, the management of debt, the effective control of the risks associated with those activities, and the pursuit of optimum performance consistent with those risks.

Human Resources Implications

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

Equalities

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

Legal Implications

52. 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 the CIPFA Treasury Management Code of Practice. The scheme of Minimum Revenue Provision ("MRP") was set out in former regulations 27, 28 and 29 of the *Local Authorities (Capital Finance and Accounting) (England) Regulations 2003* [SI 2003/3146, as amended] ("the 2003 Regulations"). This system has been revised by the *Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008* [SI 2008/414], ("the 2008 Regulations") in conjunction with the publication by CLG of this MRP guidance.

Crime and Disorder Implications

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

Information Technology Implications

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

Property Implications

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

Risk Management

55. The treasury function is a high-risk area because of the level of large money transactions that take place. As a result of this there are strict procedures set out as part of the Treasury Management Practices statement. The scrutiny of this and other monitoring reports is carried out by Audit & Governance Committee as part of the council's system of internal control.

Recommendations

56. The Executive is advised to:
    a) **Note** the 2009/10 performance of the Treasury Management activity, movements on the Venture Fund and the Treasury Management Outturn.
    b) **Note** the movements in the Prudential Indicators.

Contact Details

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Wards Affected: All ☐ None

Specialist Implication Officers: None

For further information please contact the author of the report

Background Papers

Cash-flow Model 2009/10, Investment Register 2009/10, PWLB Debt Register, Capital Financing Requirement 2009/10 outturn, Venture Fund 2009/10, Prudential Indicators 2009/10, CIPFA Statistics 2008/09.