

**Executive Member for Corporate Services and 10 June 2008
Advisory Panel**
Report of the Director of Resources

Treasury Management Annual Report & Review of Prudential Indicators

Summary of Report

1. This reports updates the Executive Member on Treasury Management performance for 2007/08 compared against the budget taken to Council on 21 February 2007. The report summarises the economic environment over the 2007/08 financial year and reviews treasury management performance in the following areas:
 - Borrowing,
 - Investments,
 - The Venture Fund,
 - Treasury Management Outturn and
 - The Prudential Indicators.

Consultation

2. The majority of this report is for information purposes and reporting 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

3. Previously this report has requested Member approval for the adoption of the Treasury Management Policies and Practices for the current financial year as recommended by Chartered Institute of Public Finance and Accountancy (CIPFA). However to enable the Policies and Practices to be in place for the 1 April 2008 the revised Policies and Practices were included in the 2008/09 Treasury Management Strategy Statement and Prudential Indicators report on 12 February 2008) were Members were asked to recommend approval by Council (at Budget Council 21 February 2008).

Corporate Priorities

4. Effective treasury management is concerned with the management of the Council's cash flows, its 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. By effectively and proactively managing its treasury activities the Council will meet its Corporate Strategy Value of "Encouraging improvement in everything we do".

Economic Background

5. The performance of the Council's treasury management function is an outcome of the short term investment and long term borrowing decisions which were affected by the following economic conditions during the 2007/08 financial year.
 - a. When the 2007/08 budget was set in January 2007, the Bank of England base rate was at 5%. Expectations at this time suggested that the rate would remain at this level for the majority of the year, with the possibility of a quarter of a per cent (0.25%) reduction to 4.75% in early 2008. However, there was a surprise increase in rates in early 2007, as the Bank of England reacted to newly emerging inflation concerns. The bank rate therefore started the financial year at 5.25% with expectations pointing to further increases. An increase in rates to 5.5% duly occurred on 10th May 2007 after the Governor of the Bank of England had written a letter to the Chancellor in April explaining why the Consumer Price Index (CPI) had risen to more than 1% above the official CPI inflation target of 2%. Another rise was delivered on 5th July when Bank Rate rose to 5.75% and the markets fully expected Bank Rate to increase again. The August Inflation Report indicated that the Bank Rate needed to rise to 6% to keep inflation at target in two years time.
 - b. August, as it transpired was the peak of interest rates as what has become known as 'the credit crunch' hit the markets and the global economy. Fears arose that a large number of sub prime loan investments would turn out to be worthless and this in turn would lead to bankruptcies amongst the banking sector. As a result of the ensuing reluctance of banks to lend to each other, the Federal Reserve Bank in the US injected \$38bn of liquidity into the markets on 9th August. The European Central Bank (ECB) followed suit but the Bank of England stood on the sidelines only making cash available at a penal rate of 1% above Bank Rate. On 17th August the Federal Reserve cut interest rates by 50 basis points (bp) to 5.25%. The dislocation in the markets continued throughout the summer until on 14th September it was announced that the Bank of England had

provided billions of pounds of financial support to Northern Rock. Northern Rock had been affected by the drying up of the wholesale money markets which provided 80% of its funding. On 17th September the Chancellor announced a Government guarantee for all deposits held at the stricken bank. At its October meeting the Monetary Policy Committee (MPC) declined to cut Bank Rate, being concerned about the inflation outlook. UK data continued to be robust during the autumn although CPI dropped to 1.8% in September. The 3 month London Inter Bank Bid Rate (LIBID) still remained well above Bank Rate. On 31st October the Federal Reserve cut rates again to 4.50% and the following day they added \$41bn of reserves in an attempt to free up the markets. The MPC eventually cut Bank Rate on 6th December to 5.50% as concerns about the economy and the credit crunch mounted.

c. 2008 was ushered in with major fears about the global economy. Stock markets fell sharply and government bond yields fell. On 22nd January the Federal Reserve cut rates, this time by 0.75% to 3.5%, and once more on 30th January to 3%. The MPC followed suit in February cutting Bank Rate by 0.25% to 5.25%. In late February and March the markets seized up again, forcing concerted liquidity intervention by the world's central banks, initially to little avail. The year ended with the money markets anxious and nervous and the interest rate on 3 month investments 0.75% above bank rate.

d. Figure 1 shows the actual base rate movements since 2004/05 with predictions from economic commentators for 2008/09 to 2010.

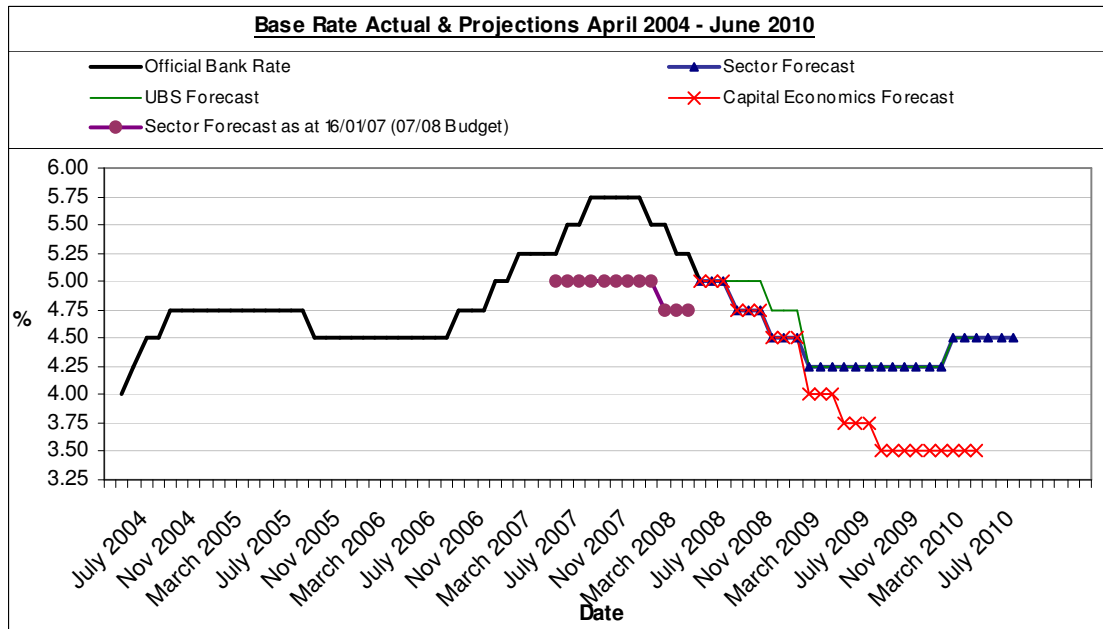


Figure 1 - Base Rates 2004- 2010 as at April 08

- e. Money Market rates have been extremely volatile since August with the development of the credit crunch leading to a great deal of uncertainty in the markets. Due to the volatility, longer term rates (3 months to 12 months) have been favourable at various points throughout the year but have been difficult to pick off due to the uncertainty regarding the short term direction of interest rates. Figure 2 illustrates the volatility of the money markets over 2007/08 financial year. The graph highlights the expected level of 3 month money market rates (3 month LIBOR) under normal trading circumstances (which is assumed here to be +0.30% above base rate) and when compared to the 3 month line illustrates the large variance between what would usually be seen and the much higher rates available due to the unusual market conditions. The variance has been as great as 0.86% which over the course of a 3 month investment of £1m would give additional interest earned of £2,144.
- f. The higher than budgeted interest rates have resulted in the Council earning £553k more interest than initially anticipated.

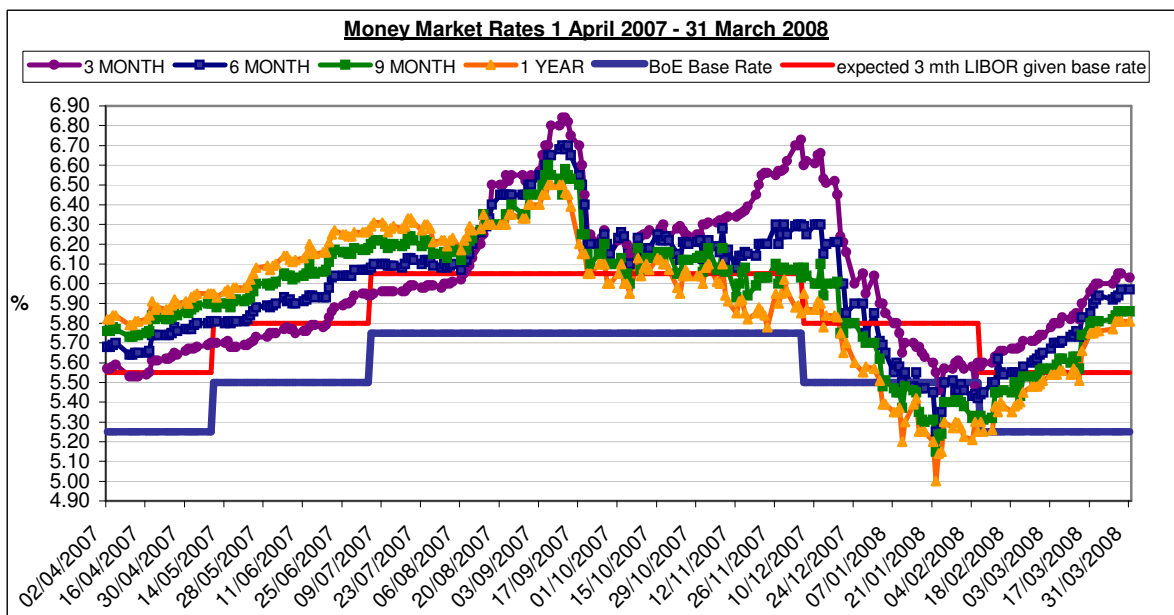


Figure 2 - Money Market Rates 2007/08

Long term Borrowing

6. The Council is permitted to borrow to fund capital expenditure. 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. This funding is linked to the delivery of capital investment programmes such as the Local

Transport Plan and Schools' Modernisation programmes. The introduction of the Prudential Code in April 2004 gives the Council more flexibility in respect of how much and when it borrows. Under the Prudential Code, Councils are free to borrow up to a level that is deemed prudent, affordable and sustainable and within their prudential indicator limits. Any borrowing that is undertaken using the prudential code framework is not supported by government and has to be funded by the Council.

- The Council's borrowing strategy is to borrow primarily from the PWLB when the rates are advantageous and hold back on borrowing when rates are relatively high following advice from the Councils treasury management advisors (Sector Treasury Services). The Council set a trigger point for taking long term borrowing of 4.25% during 2007/08. Long term borrowing rates for the 45-50 year period started the year at the 4.45% mark fluctuating throughout the year between 4.38% and 4.90%. Figure 3 illustrates the PWLB rates (the grey area showing rates between 25 and 50 years) for 2006/07 – 2007/08 including the loans borrowed by the Council.

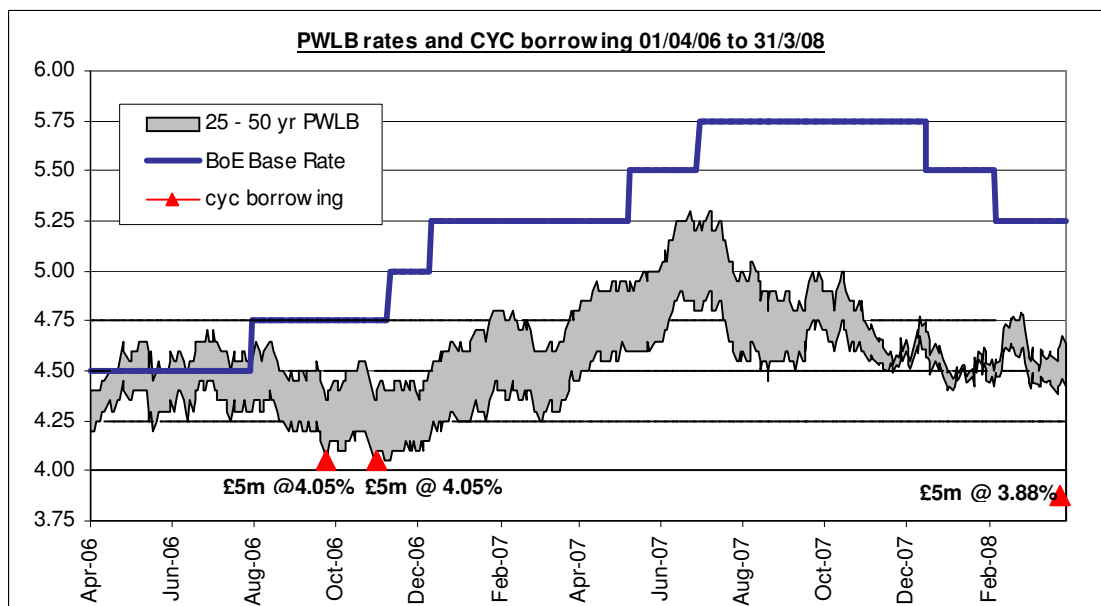


Figure 3 - PWLB rates vs. Bank of England vs. CYC borrowing levels

- The volatility in yields was a direct reflection of the massive turnaround in interest rate sentiment brought about by the sub-prime crisis in the US. A radical change to the PWLB rate structure was introduced by the Debt Management Office (DMO) on 1st November when they moved to single basis point moves in their rates and introduced a separate repayment rate at the same time, at a level significantly below the rate at which they would lend new money.

9. The Councils long term borrowing started the year at £103.4m with one new loan being taken out in March 2008. The additional loan totalling £5m was a Lenders Option Borrowers Option (LOBO) loan at a rate of 3.88% per annum fixed for the first 3 years (until 1 April 2011). After the first 3 years the lender (Dexia Bank) have the option to raise the interest rate payable and the Council has the option to repay if it does not wish to pay the higher rate. If the rate is not raised the loan will continue at a rate of 3.88% with the option for the lender to increase the rate every 6 months thereafter (along with the option for the Council to repay). The Council is in a position to repay approximately £5m of debt per annum due to the Minimum Revenue Provision (MRP – the statutory set aside made each year for the repayment of debt). The Council will not therefore be exposed to any additional liquidity risk or interest rate risk due to holding this loan. Figure 5 shows the
10. One loan was repaid during 2007/08 with the borrowing at the end of the year was £104.4m. Table 1 summarises the movement in total Council borrowings during the year. The combination of higher than expected cash balances and PWLB rates not falling low enough, resulted in the decision to delay borrowing in 2007/08. This delay in borrowing, coupled with borrowing less than anticipated and at a lower rate than anticipated has resulted in an underspend of £482k against the start budget.

	Date	£	Prevailing Base Rate	Weighted %	Year of Maturity
Total Debts as at 1/4/07		103,364,956	4.50%	4.630%	
Less Loans Repaid		4,000,000		4.35%	2007/08
Plus New Loans	26 March 2007	5,000,000	4.50%	3.88%	2077/78
Total Debts as at 31/03/08		104,364,956	4.50%	4.605%	

Table 1 - Movement In Long Term Borrowing 2007/08

11. 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. The £5m loan was taken over a 69.5 year period to allow the most competitive rate to be gained. It should be noted that should the yield curve change the Council would move to borrowing shorter term money. The borrowing of long duration loans also reflects the Councils underlying need to borrow for capital purposes is forecast to rise steadily year on year for the foreseeable future and reflects the long term of the assets that it is financing. Figure 4 illustrates the 2007/08 and 2008/09 maturity profiles of the Council's outstanding loans.

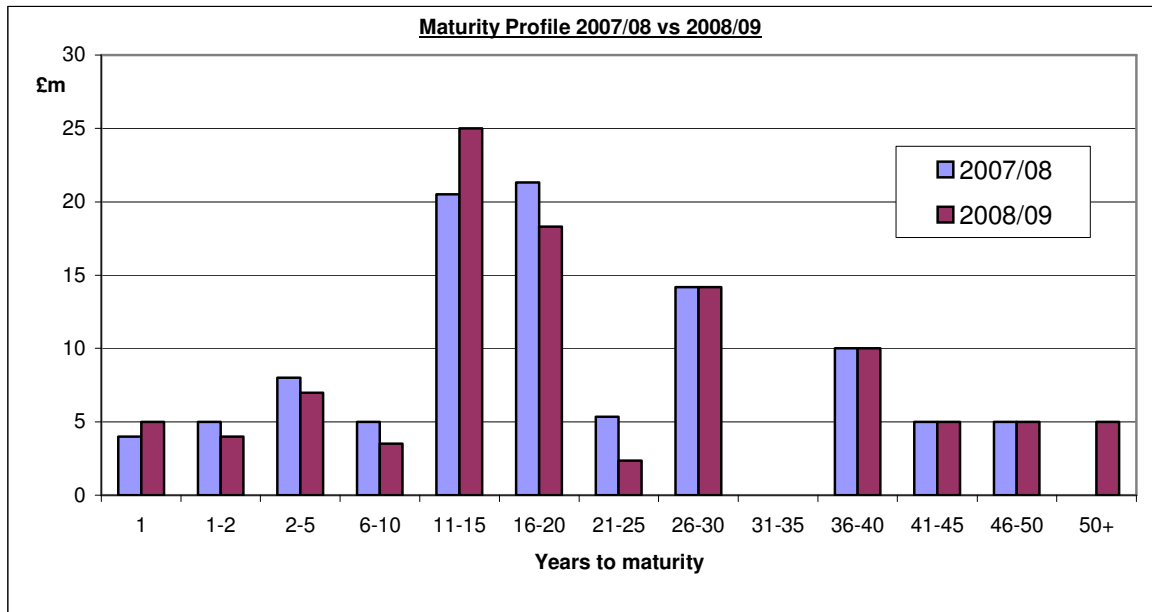


Figure 4 - Debt Maturity Profile 07/08 vs 08/09

12. As a result of the borrowing undertaken in-year, the average rate of interest on the Council's long term borrowing has fallen from 4.63% in 2006/07 to 4.605% by the end of 2007/08. This is 0.04% lower than the latest available average long term borrowing rate (source Sector 2007/08) for unitary authorities of 4.67%. Although the Council's average rate is lower than other similar authorities where it is not for the Club Loan of £10m at a rate of 7.155% which the Council is unable to restructure the Council's consolidated rate of interest could be as low as 4.35% (assuming the £10m Club loan were to be replaced at a level of 4.5%) Figure 5 shows the Council's long term borrowing compared to the national average and other unitary authorities.

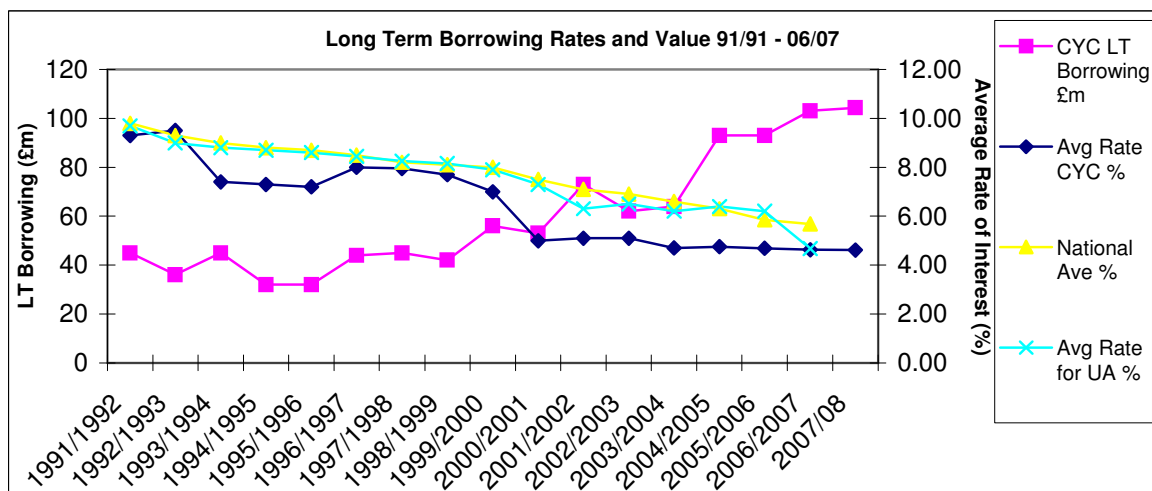


Figure 5 - CYC borrowing vs National Average vs Unitary Authority

Debt Restructure

13.No debt restructures occurred during 2007/08 although the treasury management team monitor the markets daily for rates that will allow favourable restructures. The council is still benefiting from restructures made in previous years which have considerably lowered the average debt interest rate in comparison with other unitary authorities.

Short Term Investments

14.The Council's average balance available for investment has increased significantly from £44.6m in 2006/07 to £67.8m in 2007/08. This increase in cash balances has resulted in additional interest earned over the budget position of £919k. The reasons for the increase in balances are:

- Early receipt of £10m of capital grants which were not applied in 2007/08.
- 2006/07 General fund underspend of c £3m
- 2007/08 General Fund underspend of approximately £3m
- 2006/07 Capital Programme Slippage of £5.5m
- In year Capital programme slippage of c£11m against start budget
- An increase in Housing Revenue Account working balances (approximately £1m)
- Surplus on the 2006/07 collection fund of c£1m.

15. The day to day cash balances varied in relation to the Council's receipts and payments cycle. Cash balances reduced at the end of the month due to the monthly payroll and increased at the beginning and mid point of the month with the receipt of Council Tax, Non Domestic Rates and major grants. Annex A shows the movement in daily cash balances over the year and compares this against average cash balance forecast at 1 March 2007. All surplus cash balances were invested with authorised counterparties in accordance with the Council's Treasury Policy Statement. Interest earned during the year on the cash balances totalled £3.924m (net of interest payable on temporary borrowing), which represents a 5.78% rate of return. This is 0.20% better than the average 7 day London Inter-Bank Bid Rate (LIBID) of 5.58%, the standard benchmark for short term cash management and 0.15% better than the Councils treasury management advisors' model investment portfolio which is based on cash available for long term investment only and not day to day cash flow funds. The interest earned was £1.472m higher than budgeted. This is attributable to higher than anticipated interest rates (£553k) and the increase in average balances (£919k).
16. Taking into account the direct costs of dealing, the in-house team achieved a net trading surplus of £3.87m. This is equivalent to a return of 5.71%, which is 1.17% above the average rate paid by the bank on credit balances held in the Council's accounts, as shown in Annex B. The added value of carry out the money market trading is estimated at £0.796m compared to £0.462m in 2006/07.
17. During the year, the Council has made 171 investments totalling £378m, compared with 144 totalling £306m in 2006/07. This increase is due to improved management of the Council's balances which has enabled the treasury team to take even more advantage of the market conditions brought about by the credit crunch. This improved management is demonstrated by the increase in money market investments that have taken place rising from 30 (£93.6m) in 06/07 to 69 (£176.2m) in 07/08. Money market investments accounted for 47% in cash terms of all investment decisions in 07/08 up from 31% in the previous year. Treasury management officers have been able to achieve returns above the levels of the standard call accounts by investing funds on the money markets for periods of longer than 2 months. Of the 69 fixed term deposits placed on the money markets during 2007/08 23 have been for a week or less with 46 being for a period of 1 months or more. Annex C gives details of investments for periods greater than 3 months.
18. A number of institutions keen to accept Local Authority investments have been offering competitive interest rates on short term funds, typically paying Bank of England Base Rate as a minimum on all balances held with them.

Such competitive rates have seen call accounts earn higher returns than money placed in fixed term deposits for periods up to 1 and 2 months. This has seen the Council take advantage of such rates actively operating 3 accounts:

- i. Alliance & Leicester call account opened in July 2007 paying between 0.03% and 1.14% (averaging 0.33%) above base rate.
- ii. Bank of Scotland 7 day notice base plus account paying between 0% and 1.19% (averaging 0.29%) above base rate.
- iii. Anglo Irish Star call account paying between 0.20% below base rate and 0.30% above base rate (averaging 0.07% above base rate).

19. As highlighted above the overall investment pattern has changed with 60% of investments in 2007/08 being made into the call accounts compared to almost 80% in 2006/07. This reflects the higher returns that longer duration fixed term deposits have been offering over call account returns for period over 2 months. The split between call account deposits and brokers used is illustrated in figure 6.

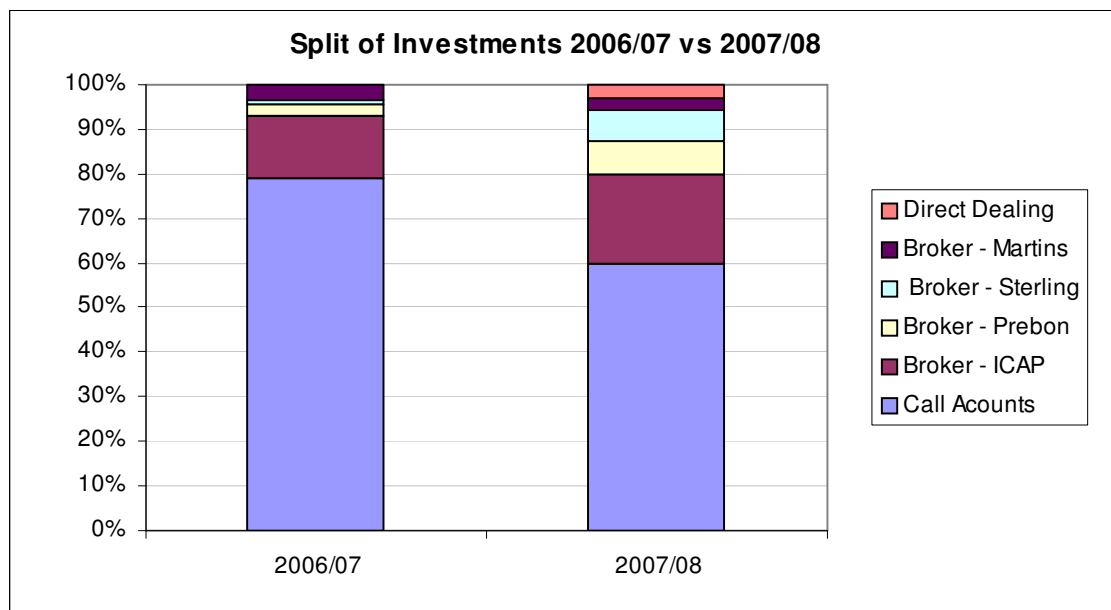


Figure 6 - Split of Investments by broker used

20. Additional information is provided in Annex D about the scale of money market activities for 2007/08 compared against 2006/07 and the relative uses made of different types of lending institutions and the various Council brokers.

21. The Treasury Team continually monitor the performance of the money market brokers with all brokers continuing to provide a satisfactory service to the Council. It is intended to retain all four brokerage organisations.

Venture Fund

22. The Venture Fund is used to provide short to medium term investment for internal projects which 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 2.

	£'000
Balance at 1 April 2007	1,611
New Loan Advances	(556)
Loan Repayments Received	273
Net Interest Received	26
Repayment 05/06 transfer to fund capital programme	1,380
Balance at 31 March 2007	2,734

Table 2 - Venture Fund Movement 2007/08

23. New loan advances were made in 2007/08 for Silver Street Structural Repairs and LPSA2 07/08. 7 existing schemes repaid their annual instalments totalling £273k.

24. The repayment of the 2005/06 transfer for funding the capital programme relates to the shortfall in capital receipts in 2005/06 which left the Council having to borrow to fund the programme. This option would have incurred a statutory minimum revenue provision charge of 4% of any borrowing taken. The option was therefore taken to borrow from internal earmarked reserves thus avoiding minimum revenue provision (MRP) charges. The £1380k repayment represents the reversal of this transaction in 2007/08 and all of the adjustments made are now fully unwound leaving the venture fund fully repaid on this element.

25. When all the outstanding loans are repaid back to the Venture Fund the total balance will stand at £4m. It is currently projected that in 08/09 £155k of repayments will be made leaving the balance at £2.889m. The Administrative Accommodation project will need to drawdown funds from the Venture Fund of c£2.1m which can be met from the fund at its current level.

Financial Implications - Budget Outturn

26. Treasury Management activity is contained within the Corporate Budget, which was approved by Council on 21st February 2007 at £7,433k for 2007/08. Since the budget was set there have been a number of changes made by the Executive and under officers delegated power which has resulted in a revised budget of £7,267k. The outturn is £4,980k, an underspend of £2,287k. The main report explains the underlying reasons for this underspend, namely the increase in cash balances and favourable conditions on the money markets as a result of the credit crunch. Table 3 illustrates the breakdown in the underspend and the paragraph reference to the underlying factors that have caused it.

	Paragraph	Outturn £000
Long Term Borrowing less than planned	10	-473
Long Term Borrowing lower interest rates	10	-9
Increase in cash balances	15	-919
Increase in interest rates	15	-553
Provision for Debt Repayment	27	-156
BCCI Dividend	28	-115
Minor Budget Variations		-62
TOTAL		-2,287

27. The 2006/07 year end slippage on the capital programme, reduced the capital financing requirement that had to be funded from borrowing. This had a knock on effect of reducing the level of provision required to repay debt in 2007/08. This has resulted in a £156k underspend against the start budget.

28. The Council received two Bank of Credit and Commerce International (BCCI) dividends during 2007/08 as the fifth and sixth dividends payments were made. A total of £115k was received taking the total recovered losses to £1,726k, which is 91% of the investments made with the BCCI in 1990 when it collapsed. The amount recovered is now £410k more than was written off by the Council and represents additional unbudgeted for income.

Change to Treasury Management Policy

29. In March 2008 the Department for Communities and Local Government (DCLG) passed new legislation that gives Councils more flexibility in how it provides for the repayment of debt. The former regulations imposed a Minimum Revenue Provision (MRP) to be made of 4% of the Council's underlying debt requirement. Any given years MRP payment was based on the Council's Capital Financing Requirement (CFR) as at 31st March of the preceding year.

30. The new regulations allow Council's to make a "prudent" provision for the repayment of debt, and give Council's four options in determining what is prudent. The regulations state that the Council has to formally adopt a policy which sets out how it will provide for the repayment of debt within the four options provided. These are:
- a. The regulatory method – 4% of the borrowing outstanding;
 - b. The Capital Financing Method – 4% of the Council's Capital Financing Requirement;
 - c. The Depreciation Method – repayment of the debt over its depreciation life;
 - d. The Asset Life Method – repayment over the life of the asset to which the borrowing has been taken to fund.
31. Options a and b have broadly the same impact on the Council, and the DCLG recommends that this method is used in relation to the government supported borrowing. Option c would take the maximum repayment period to 40 years on operational land and buildings. Option d would take the maximum repayment period up to 60 years for some assets. There are merits in adopting all the options, however, in terms of prudence it is recommended that the Council adopts option b for government supported borrowing and option d for unsupported borrowing, with a caveat that the asset life is an absolute maximum and wherever possible the debt should be repaid over a shorter period. To this end it is recommended that the standard repayment period should be up to 25 years or less if the asset life is shorter, unless approval is sought to extend the repayment provision over a longer period and a formal business case is made to the Executive to do so.
32. With all debts, the longer the repayment period the more is paid in interest over the period of the loan. It is therefore deemed as prudent to reduce the period over which the repayments are made. Annex E outlines a simple flow chart of how the policy will work.

Review of the Prudential Indicators

33. In accordance with the Prudential Code, the Prudential Indicators set by full Council on 21st February 2007 must be reviewed. Full detail on the indicators are given in Annex F, but some of the key points are:
- Size of the Capital Programme (Indicator 1) - The indicator set for the size of the 2007/08 Capital Programme was an estimate of £42.8m and the outturn was £40.8m. The programme outturn was lower than in 2006/07 as the Council prepared for the two major schemes at Joseph Rowntree and the new Office Accommodation. There has been slight overall slippage on some projects, all of which should be completed in 2008/09..

- Net revenue Stream (indicator 2) - This indicator represents how much borrowing for the capital programme will cost as a percentage of the net revenue stream. The General Fund indicator is 3.76% compared to a budgeted level of 6%, with the reduction being mainly attributable to the high level of interest earned on cash balances in 2007/08 which reduces the Council's net debt position during the year. The Housing Revenue Account (HRA) version of the indicator is 2.39% compared to the budgeted level of 3.31%, the difference is again due to higher than anticipated cash balances serving to reduce the HRA net debt position.
- Incremental Impact on the Level of Council Tax (Indicator 3) – This indicator shows the impact of capital investment decision on the bottom line level of Council Tax. The Council can fund its discretionary capital programme from two main sources, from unsupported borrowing or using capital receipts from the sale of surplus assets. With the capital receipts the Council has a choice of whether to reinvest in other capital assets or repay debt. The Council's policy is to recycle its capital receipts in to improving other Council assets and this therefore has an impact on the level of Council Tax. This coupled with a small level of unsupported borrowing has resulted in a small increase in the underlying level from £4.34 per Band D charge, to £6.18.
- Capital Financing Requirement (CFR) (Indicator 5) - The Council's CFR (underlying need to borrow) at outturn was £79.9m a decrease of £12.4m against an estimated figure of £92.3m. The reduction is due to slippage on the capital programme and the decision to use to over achievement in capital receipts in 2006/07 to reduce the Capital Financing Requirement rather than borrowing to finance capital spend.
- Authorised Limit / Operational Boundary (Indicator 6) - The Council took on additional debt of £5m, but repaid £4m leaving the Council's total level of debt at £104.4m. The Council's Operational Boundary (maximum prudent level of debt) was revised to £118.9m as part of the 2008/09 budget setting process and the Authorised Limit (maximum allowed debt) revised to £128.9m. Debt levels have therefore remained within the limits set.
- Details of all the Prudential Indicators can be found in Annex F.

Human Resources Implications

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

Equalities

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

Legal Implications

28. 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. 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 now been radically 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. This requires the Council to adopt of a revised policy on the MRP as highlighted in paragraphs 29 to 32.

Crime and Disorder Implications

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

Information Technology Implications

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

Property Implications

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

Risk Management

32. 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.

Recommendations

33. The Advisory Panel are requested to advise the Executive Member to:
- Note the 2007/08 performance of the Treasury Management activity, movements on the Venture Fund and the Treasury Management Outturn.
 - Note the movements in the Prudential Indicators.
 - Adopt the proposed policy on the Minimum Revenue Provision as set out at Annex E and Paragraphs 29 to 32.

In order to comply with the CIPFA Treasury Management in Public Services Code of Practice and the CIPFA Prudential Code.

Contact Details

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Report ✓ Date 28/05/08
Approved

Wards Affected:

All
None

Specialist Implication Officers: None

For further information please contact the author of the report

Background Papers

Cash-flow Model 07/08, Investment Register 07/08, PWLB Debt Register, Capital Financing Requirement 07/08 outturn, Venture Fund 07/08, Prudential Indicators 07/08, Statistics 07/08.

Annexes

*Annex A - Cash Balances Graph
Annex B - Surplus on Money Market Trading
Annex C – Investments taken over 3 Months
Annex D - Money Markets Trading Statistics
Annex E – MRP policy flowchart
Annex F - Prudential Indicators 07/08*