CITY OF
YORK
COUNCIL

Executive Member for Corporate Services and Advisory Panel **9 December 2008**

Report of the Director of Resources

Treasury Management Second Monitor Report

Summary of Report

1. This report updates the Executive Member and Advisory Panel on the Treasury Management performance for the period 1 April to 31 October 2008 compared against the budget presented to Council on 21 February 2008.

2. The report highlights the economic environment for the first seven months of the 2008/09 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 budget, Strategy and Prudential Indicators on 21st February 2008. This resulted in an approved treasury management budget of £6.937m for 2008/09.

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 maximises the interest earned from surplus cash balances and minimises 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 Bank of England base rate started 2008/09 at 5.25%. The Monetary Policy Committee (MPC) responded to the weakening outlook for economic activity by cutting interest rates to 5% in April. Growing inflation fears led the financial markets to price in the possibility that the next move in interest rates would be upwards, with markets expecting that interest rates would be raised to 6% by next summer. The second quarter of 2008 saw a change in sentiment with the financial crisis plumbing new depths as policymakers stepped up their response to problems, the credit crunch took its toll on economic activity, pressures on households intensified, companies cut more jobs, public finances deteriorated, inflation concerns faded and the global economy faltered. A number of financial institutions on both sides of the Atlantic failed with Lehman Brothers allowed to collapse contributing to the intensification of the problems in the money markets.

   b. More evidence that the credit crunch was taking its toll on the economy was revealed later in the second quarter. The Bank of England's Credit Conditions Survey found that lenders reduced the availability of credit to both households and firms in the second quarter, and expected to do the same in the third quarter. Problematically for the MPC Consumer Price Index (CPI) inflation rose from 3.3% in May to a new record high of 4.7% in August. Most of this reflected the hefty increases in gas and electricity prices announced by the major suppliers in August and September. Some of the increase did reflect the rise in core CPI inflation, from 1.2% in March to 2.0% in August with the outlook suggesting CPI inflation would rise further in September, perhaps to 5.0%, as the last of the utility price hikes fed into the index. However with petrol prices starting to fall, it became increasingly likely that CPI inflation would drop sharply back towards the 2% target rate next year.

   c. The MPC acted in October cutting 0.5% off of the BoE base rate taking it to 4.5% as 2 year inflation expectations diminished significantly partly reflecting a marked decline in energy and other commodity prices.

   d. Despite CPI rising to 5.2% in September the MPC acted again in November cutting 1.5% off of the base rate to take the rate down to a level of 3%, the lowest since 1955. The MPC minutes documented the reasons as being the global banking system experiencing its most serious disruption for almost a century and while the measures taken on bank capital, funding and liquidity in several countries, had begun to ease the situation, the availability of credit to households and businesses was likely to remain restricted for some time. As a consequence, money and credit conditions have tightened sharply.

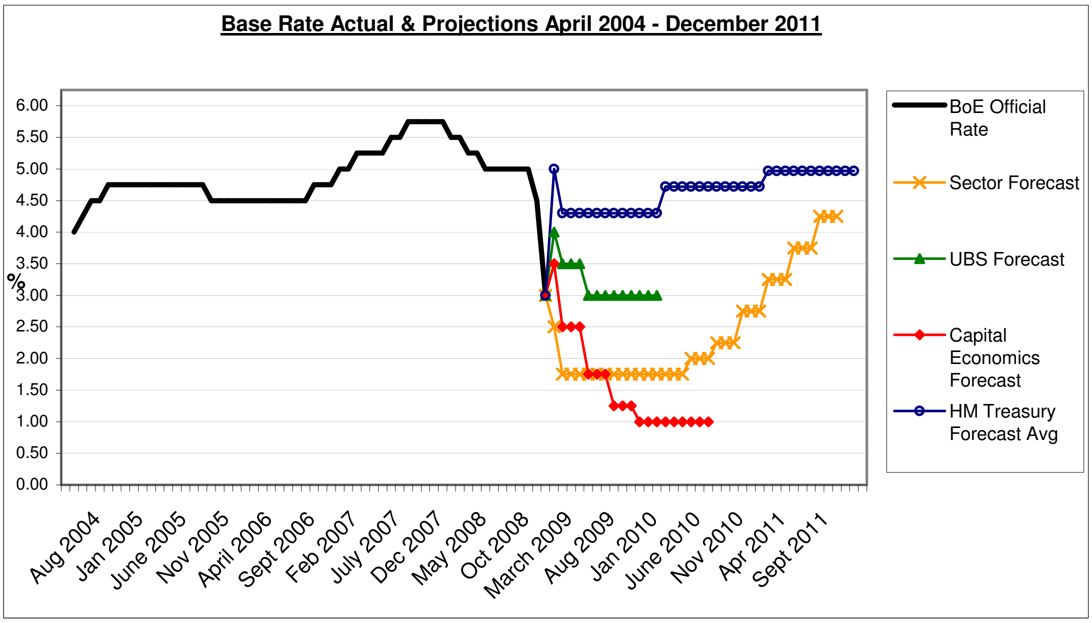

Figure 1 - Base Rate 2004 –2011 as at October 2008

e. With regard to long term borrowing, the Public Works Loan Board (PWLB) 45-50 year rate started the year at 4.43%. Rates have risen steadily from this low point up to a high of 4.82% in mid October with rates dropping back to a level of 4.49% by mid November.

f. Investment rates have risen since the beginning of the financial year when the 1 year rate was at 5.81% (1 month rate at 5.80%) to a level of 6.00% and (6.00%) by the end of the October. Rates peaked at 6.55% in the 1 year and 6.15% in the 1 month range.

g. A number of large UK banks keen to accept Local Authority investments have continued to offer competitive rates on call accounts paying Bank of England base rate as a minimum. Towards the start of the year some call accounts were paying rates equivalent or higher than could be achieved through 1 to 2 months fixed term money market investments. The Council has taken advantage of such accounts and actively operates 6 call accounts:
   i. Bank of Scotland 7 day notice base plus account has been between 0.31% and 1.63% (averaging 0.58%) above base during the period.
   ii. Alliance and Leicester call account has been between 0.40% and 1.10% (averaging 0.59%) above base rate.
   iii. Yorkshire Bank call account fixed at 0.30% above base rate.

iv. Allied Irish Bank UK call account has been between 0.25% and 0.35% (averaging 0.27%).
v. Abbey call account has been between 0.18% and 0.22% (averaging 0.22%)
vi. Anglo Irish Star call account fixed at 0.05% above base rate.

Investment Policy

8. The treasury management team has taken a prudent approach with regard to placing deposits with institutions in order to effectively control the associated risks. Decisions continue to be made using officers professional judgement based on credit ratings supplied by Moody and Fitch along with suggested colour matrices from Sector Treasury Services. All information supplied by Sector (including the Fitch and Moody credit ratings) is only used as a factor to assist in the making of the Councils investment decisions and is not used as a sole basis for any decision. The Treasury Management team does not regard the advice or information received as a substitute for the exercise of its own judgement.

9. The treasury team continues to assess credit ratings on a daily basis taking into account short and long term issuer default ratings, individual ratings and support levels as well as sovereign ratings for each country. The approved counterparty list (a list of approved investment institutions) is therefore updated on a daily basis when necessary and is one of the key treasury management documents used daily by the treasury team.

10. From a treasury management perspective the Council has not been adversely effected by the wide spread problems experienced in the economy as a result of the credit crunch. No investments were held in any of the Icelandic Banks at the time of their collapse due to the Council removing Icelandic based institutions from the approved counterparty list on 2 April 2008. From this point onward no further deposits were placed with these institutions.

Short Term Investments

11. The Councils average cash balances available for investment for the first 7 months of the year has been £60.134m, a £8.424m decrease compared to the same period in 2007/08 (£68.558m). The reasons for the decrease are:
    a) Restructuring £13.8m of Council borrowing into lower interest rate debt and achieving this by holding a open position for a duration (not refinancing until some months later).
    b) Significant increase in stage payments in relation to the Councils larger capital schemes such as Joseph Rowntree School.

12. Trading activity during the first seven months earned interest of over £2.021m, equivalent to a 5.75% rate of return. This is 0.69% better than

the average 7 day London Inter-Bank Deposit rate (LIBID) of 5.06% and 0.80% higher than the average base rate for the period.

13. Taking into account the direct cost of dealing the in-house team achieved a net trading surplus of £2.006m. This is equivalent to a return of 5.72%, which is 1.76% above the average rate 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 £617k.

14. During the first 7 months of the financial year the Council has made 85 investments totalling £215m, compared with 104 investments totalling £238m for the same period in 2007/08. This small decrease in activity is due to the slightly lower average cash balances compared to previous years and investing for longer term durations. Proactive management of the bank accounts has resulted this year in a decrease in the percentage of money market transactions from 48% in 2007/08 to 15% in 2008/09. This reflects two things, firstly core cash has been placed in longer term investments toward the beginning of the 2008/09 financial year to take advantage of higher rates in anticipation of the cut in interest rates therefore leading to fewer shorter term deposits being placed. Secondly the requirement for a higher level of cash to be kept liquid to cover the projected spending activity. Figure 2 shows the split of money market investments between the Council's four money market brokers.

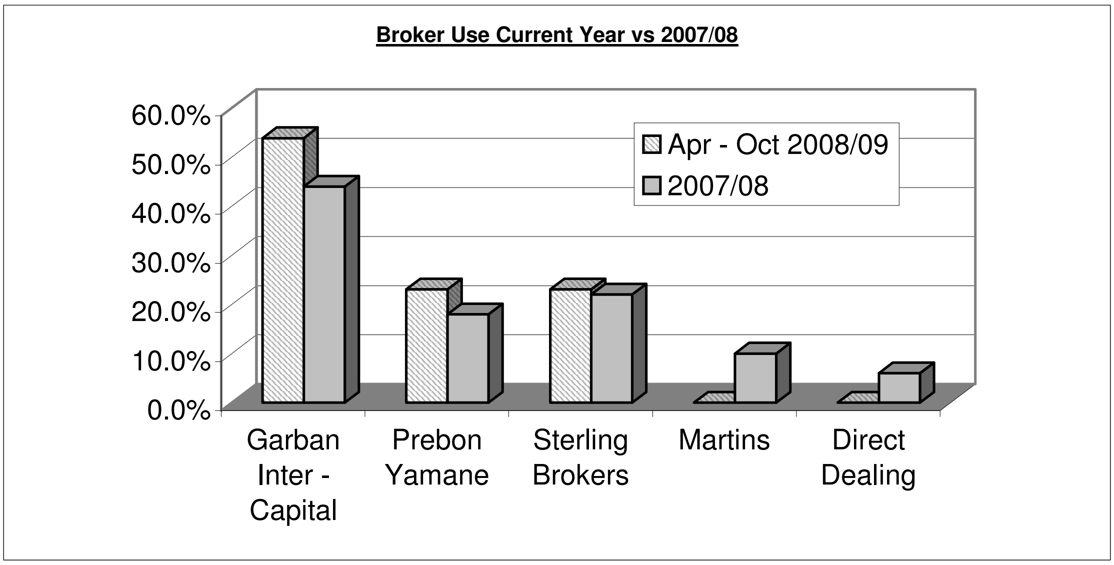

Figure 2 – Money Market Investments by broker used

15. The Council has made 13 investments via the money market brokers during the first 7 months of 2008/09. Of these only 1 has been for a month or less with 12 being for a period of greater than one month. Annex A gives details of investments made in this year for periods greater than 1 month. Annex B provides a list of all institutions the

Council currently has money invested with in fixed term fixed rate deposits.

16. Figure 3 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.

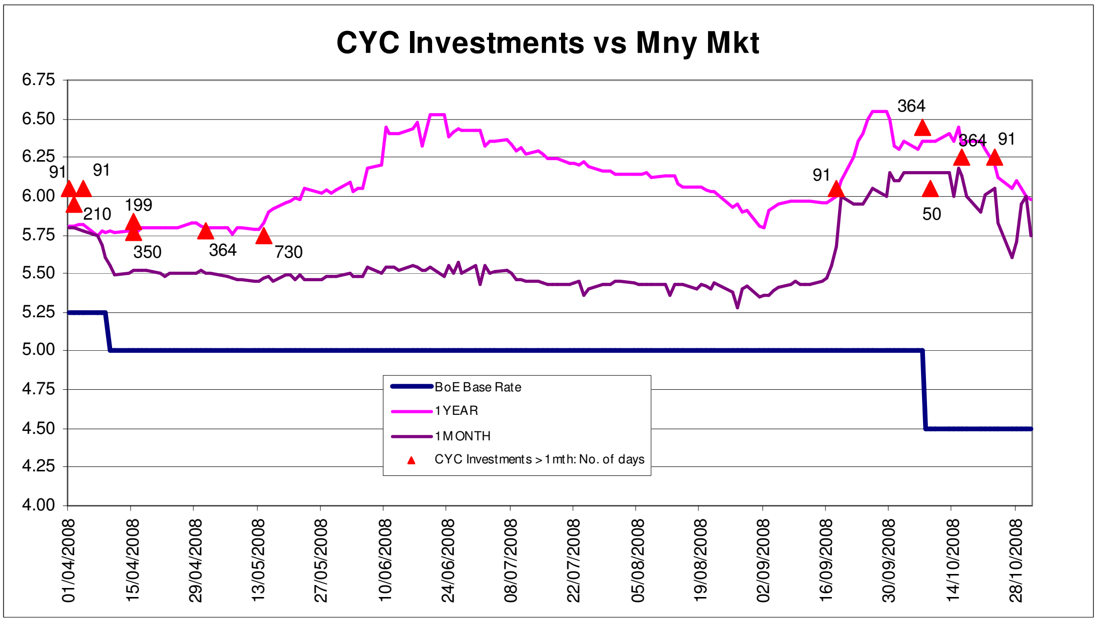

Figure 3 CYC Investments vs Money Market Rates

Long Term Borrowing

17. The Council is allowed to borrow to invest in capital projects, 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 £104.4m. One loan of £5m with a maturity date in May was duly repaid.

19. Treasury officers made the decision to restructure £13.8m of higher interest rate loans (all at 4.875%) into lower rate replacement loans. £13.8m was repaid on the 30 May 2008 generating a discount (a payment to the Council) of £85k. Treasury management officers took the decision to wait before refinancing in the expectation of Public Works Loan Board (PWLB) interest rate falling in the current economic climate. On 15 August two loans totalling £8m (both of 49.5 year duration) were taken at a rate of 4.39% with a further £4m (35 years duration) again at a rate of 4.39% being taken on 7 October.

20. A further £4.5m at a rate of 3.91% (5.5 year duration) was taken to meet the remaining refinancing requirement and also to match the Councils level of borrowing to the Capital Finance Requirement (the Councils underlying need to borrow for capital expenditure purposes). All loans taken are of fixed term duration, with the principal amount borrowed repaid at the maturity date and interest payments made bi-annually.

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 4.43% and have since fluctuated between 4.36% and 4.82%. Figure 4 shows the PWLB rates (the grey area showing rates between 25 and 50 years) since April 2006 and details when the new borrowing took place.

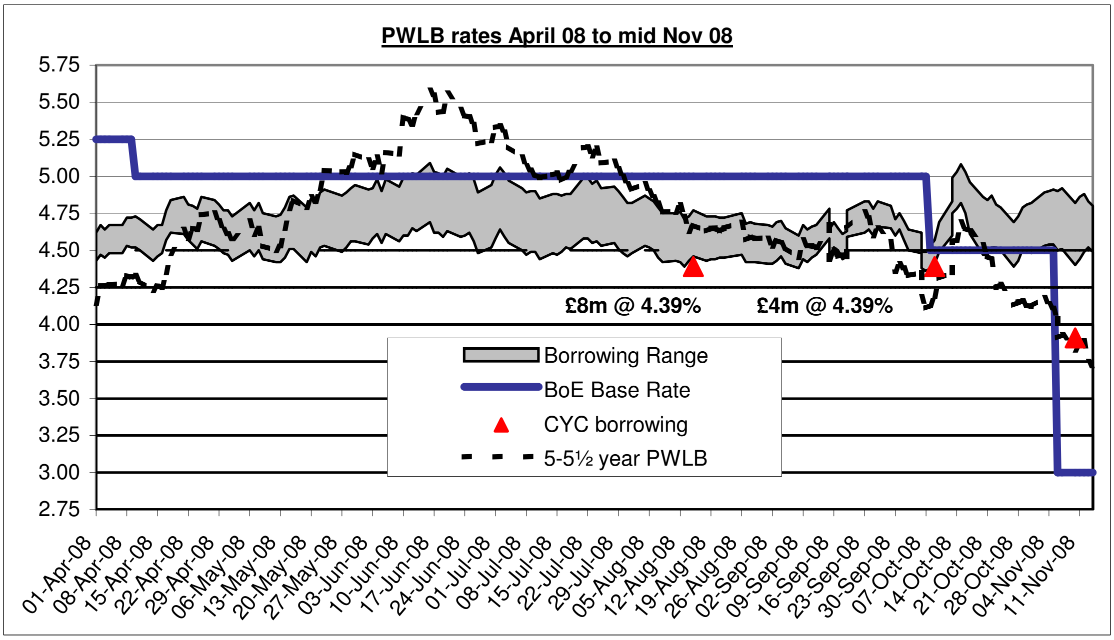

Figure 4 – PWLB rates vs CYC Borrowing Levels

22. Figure 5 illustrates the 2008/09 maturity profiles of the Council's debt portfolio updated to reflect the borrowing this year.

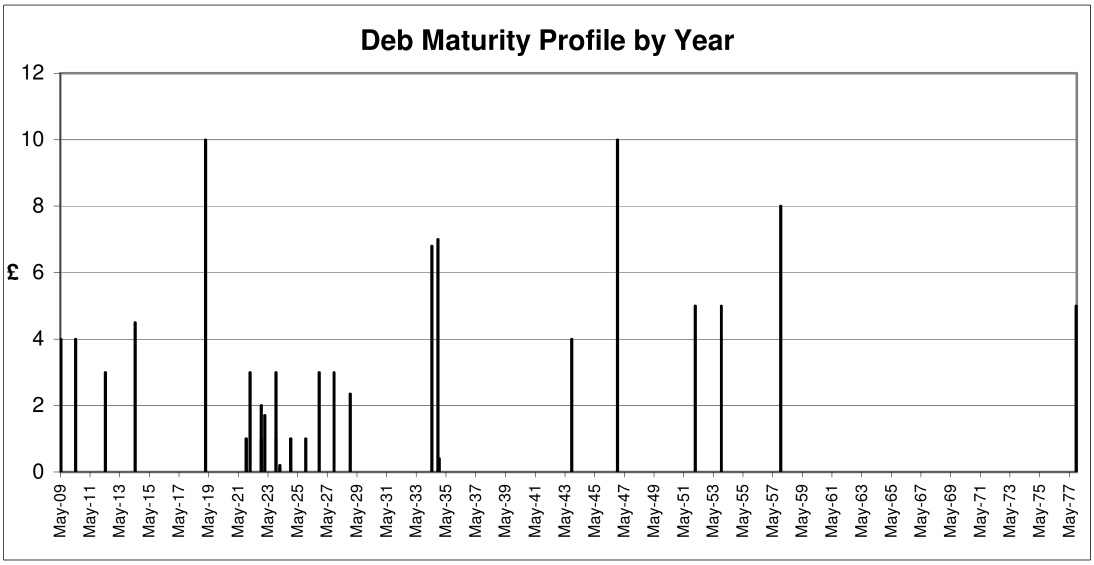

Figure 5 – Debt Maturity Profile 08/09

23. The average rate of interest on the Council's long term borrowing is 4.55%. This is 0.12% lower than the average long term borrowing rate for unitary authorities of 4.67% and 1.13% lower than the national average for all Local Authorities of 5.68% (source CIPFA Treasury Management Statistics 2006/07). Figure 6 provides an illustration of the Councils position relative to comparators since 1991/92.

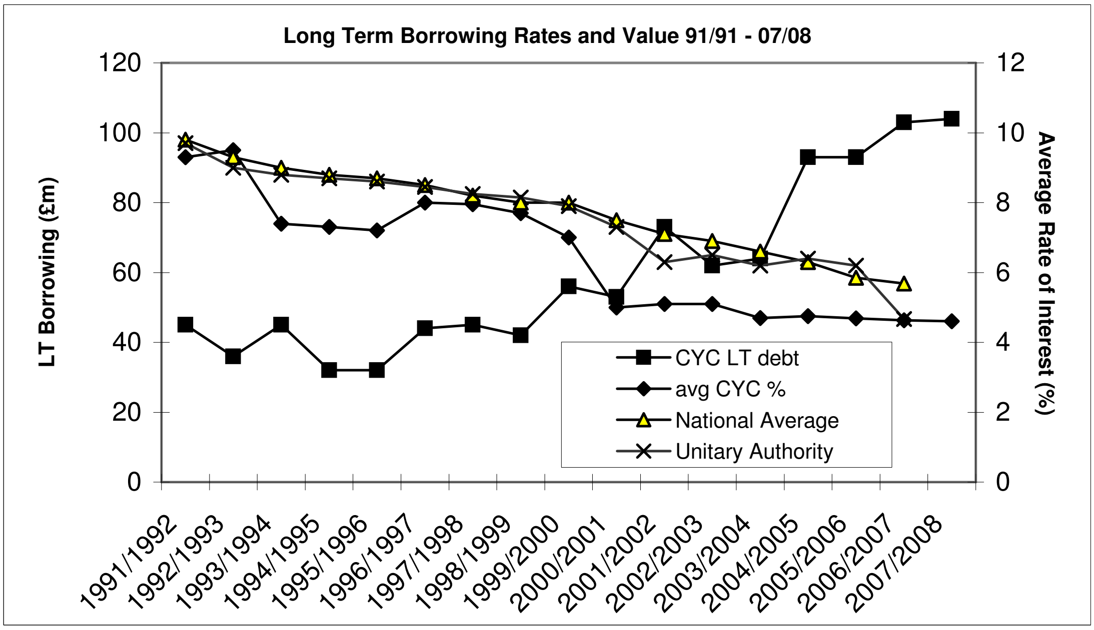

Figure 6 – CYC borrowing vs. National Average vs. Unitary Authority

Venture Fund

24. 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 1.

	£'000
Balance at 1st April 2008	**2,729**
New Loan Advances	(0)*
Loan Repayments	399
Net Interest Received	31
Balance at 31st March 2008	**3,159**

Table 1 – Projected Venture Fund Movement 2008/09

25. The asterisk above indicates there are approvals for the loan advancements of £1,210k for Local Public Service Agreement 2 (a temporary loan until the government allocation is received) and £96k for Assets in Good Repair however the specific level of funds required has not yet been requested. If the two amounts were advanced in full the balance would be £1,853k. Repayments are received from a total of 8 schemes.

Treasury Management Budget

26. Treasury Management activity is contained within the Corporate Budget and has a current approved budget of £6,937k. The projected outturn is £5,648k resulting in a estimated under spend of £1,289k. Table 2 details the individual components that make up this under spend.

	(Under)/Over Spend £000
Reduction in financing expenditure	(518)
Provision to repay debt	240
Increase in interest receivable	(978)
Minor Budgets	(33)
Total Under spend	**(1,289)**

Table 2 – Treasury Management Budget 2008/09

27. The expected Treasury Management under spend is driven by the two main areas listed above:
    a) The reduction in financing expenditure is due to a number of factors. Firstly due to the early repayment of debt as highlighted above no interest payments needed to be made until the replacement loans were taken, in addition the restructure will save £77k per annum serving to reduce the annual interest payable on the Councils debt.. Secondly, the original financing budget was based on the requirement to borrow up to a level of £110m based on specific large capital programme schemes requiring financing, due to delays the overall level of borrowing will be lower in year thus producing an under spend.

b) The increase in interest receivable is due to the continued dislocation between money market rates and base rate. The budget was set on the basis of interest rates returning to a level that reflected base rate (as historically they have), however as highlighted above rates have been as much as 1.95% above base. This continued dislocation was not forecast at the time when the budget was set. Opening cash balances proved to be higher than expected and is attributable to significant capital programme slippage of c£6m in 07/08 along with a revenue under spend of c£6m.

Prudential Indicators Update

28. Previously the Prudential Indicators have been reported as part of this report. This approach has been reviewed and owing to much of the information that feeds into the Prudential Indicators being the output of the Capital Monitoring Report then in order to provide Members with the most timely information the indicators will be reported as part of the Capital Monitor to the Executive on the 20 January 2009.

Human Resources Implications

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

Equalities

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

Legal Implications

31. 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

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

Information Technology Implications

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

Property Implications

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

Risk Management

35. 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

36. Members are requested to:
    - Note the performance of the Treasury Management Activity;
    - Note the projected underspend of £1.289m.

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

Contact Details

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	Report Approved √ Date 25/11/08

Wards Affected: All √ None

Specialist Implication Officers:

None

For further information please contact the author of the report

Background Papers

Cash-flow Model 08/09, Investment Register 08/09, PWLB Debt Register, Capital Financing Requirement 08/09 , Venture Fund 08/09, Statistics 08/09.

Annexes

Annex A – Investments over 1 month in duration
Annex B – Councils Current Investment Outstanding