CITY OF YORK COUNCIL

Meeting of the Executive Member for Corporate Services and Advisory Panel — **11 December 2007**

Report of the Director of Resources

Treasury Management Second Monitor Report & Review of Prudential Indicators

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 2007 compared against the budget presented to Council on 21 February 2007.

2. The report highlights the economic environment for the first seven months of the 2007/08 financial year and in relation to this reviews treasury management performance covering:

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

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 and Prudential Indicators on 21st February 2007. This resulted in an approved treasury management budget of £7.433m for 2007/08. A number of adjustments made at Monitor One revised this budget to £7.407m.

Consultation and Options

5. This report is for information and reporting on the performance of the treasury management function and therefore there are no options for

consideration. The budgets and prudential indicators were 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 2007/08 at 5.25% after having risen 3 times since August 2006. The Bank of England is responsible for managing the rate of inflation (measured by the Consumer Price Index – CPI) in the UK and does this through increasing and decreasing interest rates. In March the CPI breached the 3% limit set by the chancellor and this resulted in the base rate being increased twice, in May to 5.5% and again in July to the current level of 5.75% in an attempt to bring inflation back down to the 2% target level.

    b) August saw the start of what has become known as the 'Credit Crunch', where banks no longer feel confident enough to lend to each other. The credit crunch was started in the USA where mortgages were granted to people with poor credit rating histories. The mortgage companies then repackaged these debts and sold them on to main stream banks who themselves repackaged it and sold it on to pension and hedge funds. It is still unclear as to whom holds these bad debts and the banks' are reluctant to lend to each other. This resulted in the short term interest rates on money market investments increasing in response to the reduced supply of money. At one point lenders were willing to pay 6.84% on money lent for 3 months. These rates have reduced since these highs but remain higher than average because of the continued uncertainty. Figure 1 shows the actual base rate movements since 2004/05 with predictions from economic commentators for the remainder of 2007/08 and up to 2011.

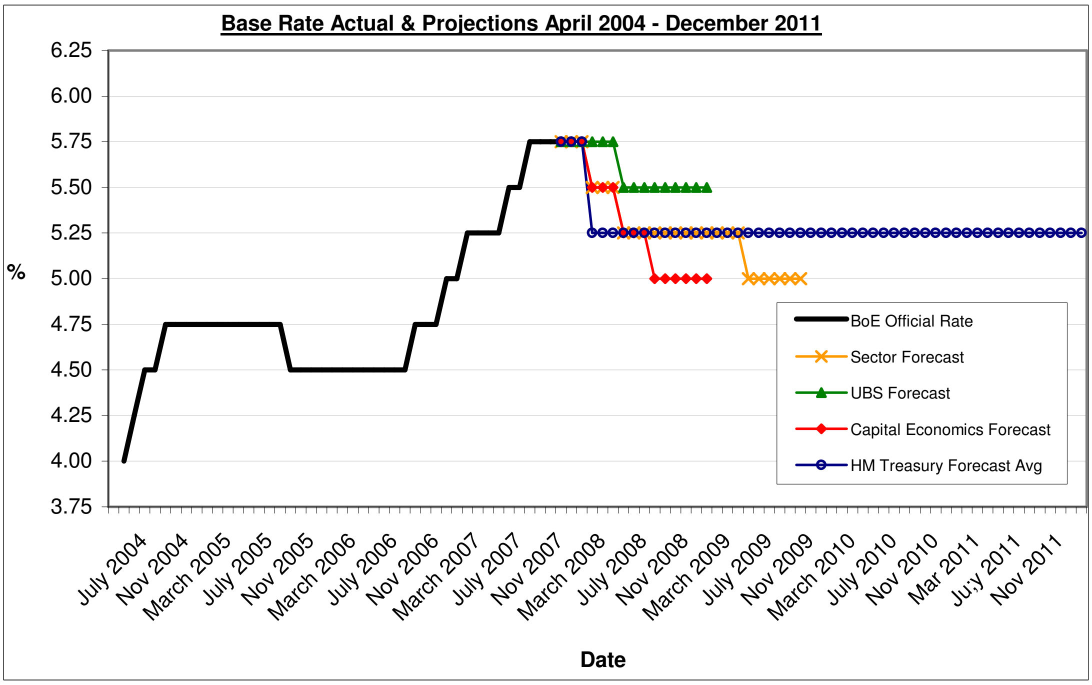

Figure 1 - Base Rate 2004 –2011 as at October 2007

c) With regard to long term borrowing, the Public Works Loan Board (PWLB) 45-50 year rate started the year at 4.45%. Rates have risen steadily from this low point up to a high of 4.90% in both mid June and July with rates dropping back to a level of 4.60% by the end of October. Although these rates are relatively low historically the current levels are currently underpinned by the rise in world inflationary expectations over the medium to long term.

d) Investment rates have risen since the beginning of the financial year when the 1 year rate was at 5.82% (1 month rate at 5.42%) to a level of 6.04% and 5.96% respectively by the end of the October. Rates peaked at 6.50% in the 1 year and 6.60% in the 1 month range.

e) A number of large UK banks keen to accept Local Authority investments have been offering competitive rates on call accounts paying Bank of England base rate as a minimum. Towards the start of the year some of the accounts were paying more than the 1 to 2 months money market deals. The Council has taken advantage of such accounts and actively operates 4 call accounts:

   i. Bank of Scotland 7 day notice base plus account is offering between 0.08% and 0.71% (averaging 0.23%) above base during the period .
   ii. Anglo Irish Star call account paying on average 0.06% above base rate.
   iii. Alliance and Leicester call account (opened in July) paying on average 0.29% above base rate.
   iv. Abbey call account paying base rate.

Short Term Investments

8. The Council's average cash balances available for investment for the first 7 months of the year has been £68.558m, a £30.206m increase compared to the same period in 2006/07 (£38.352m). The reasons for the increase are:
    a) Significantly higher opening balances as a result of the 2006/07 revenue under spend of £4m and a £5.7m reduction in the 2006/07 capital programme spend due to slippage against budget,
    b) Early realisation (between April and July) of £4m capital receipts originally scheduled for the end of March 2008,
    c) Early receipt of over £8m of grants from government departments which will not be spent until 2008/09 financial year,
    d) Projected capital programme slippage (based on current spending levels) and revenue under spend forecast of £4m.

9. Day to day cash balances vary in relation to the Council's receipt and payment cycles. Cash balances reduce at the end of the month due to the monthly payroll and increase at the beginning, and to a lesser extent mid month, with the receipt of council tax and non domestic rates. Annex A shows the movement in daily cash balances over the period April to October along with the full year projection for 2007/08. All surplus cash balances are invested with authorised counterparties in accordance with the Council's Treasury Policy Statement.

10. Trading activity during the first seven months earned interest of over £2.28m, equivalent to a 5.70% rate of return. This is 0.04% better than the average 7 day London Inter-Bank Deposit rate (LIBID) of 5.66% and 0.11% higher than the average base rate for the period.

11. Taking into account the direct cost of dealing the in-house team achieved a net trading surplus of £2.269m. This is equivalent to a return of 5.67%, which is 1.08% above the average rate paid by the bank on credit balances held in the Council's accounts, as shown in Annex B. The bottom line added by the Council's money market trading activities is estimated at £434k.

12. During the first 7 months of the financial year the Council has made 104 investments totalling £238m, compared with 84 investments totalling £183m for the same period in 2006/07. The increase in activity is due the proactive management of the bank accounts in light of the improved money market returns on offer. This has resulted in an increase in the percentage of money market transactions from 21% in 2006/07 to 48% in 2007/08. Figure 2 shows the split of money market investments between the Council's four money market brokers. Annex C provides more detail about the scale of the money market operations year to date.

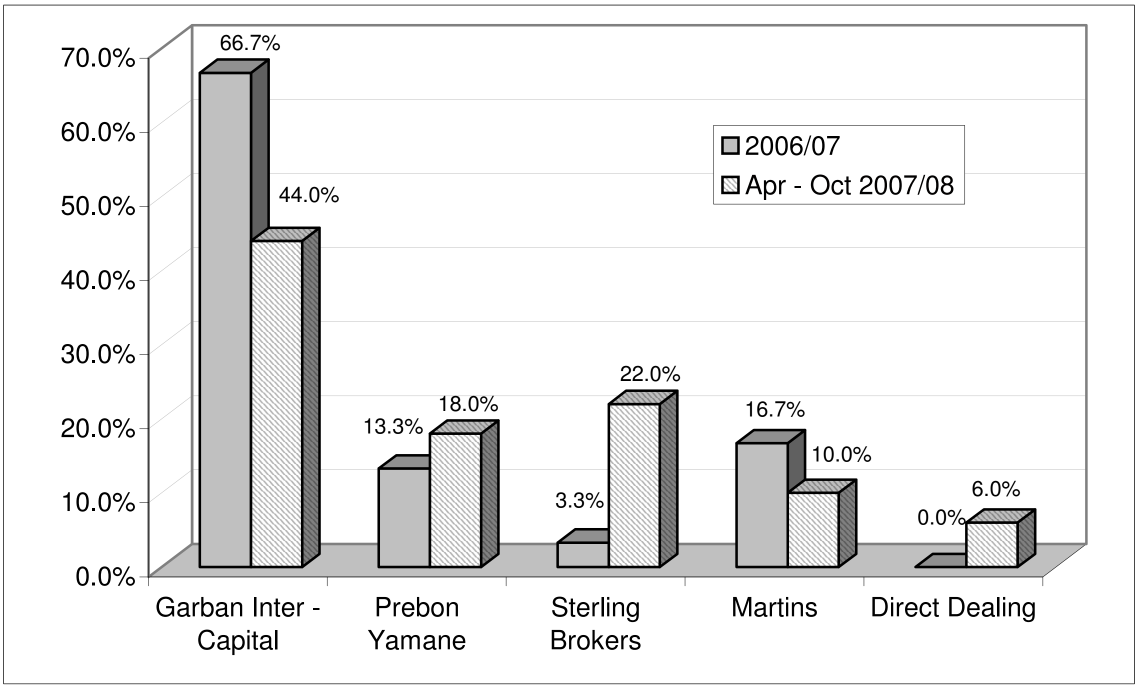

Figure 2 – Money Market Investments by broker used

13. The Council has made 50 investments via the money market brokers during the first 7 months of 2007/08. Of these 15 have been for a week or less with 29 being for a period of greater than one month. Annex D gives details of investments for periods greater than 1 month. This shows that the Council has invested £9.85m with the Northern Rock Bank during the period with £1.5m of investments being outstanding as at 31st October. The £1.5m matured on the 15th November and no further deposits will be placed with the bank.

14. 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.

15. The two investments that became live at a rate below the prevailing market rate were forward deals arranged one year prior to investing. These deals were entered in to based on the economic forecasts for interest rates at the time. They were intended as a hedge against a projected falling interest rates. The investment made at 5.08% for £3m was taken at a time when interest rates were forecast to be between 4 and 4.5% over the investment period. The investment made at 5.3% for £4m was taken when rates were forecast to be between 4.5% and 4.75% during the investment period. These loans represent £7m out of projected average balances of £68m. If rates were to have fallen in line with projections then £61m would have been affected by the general fall in the market, rather than the £7m that has been affected by the rising market.

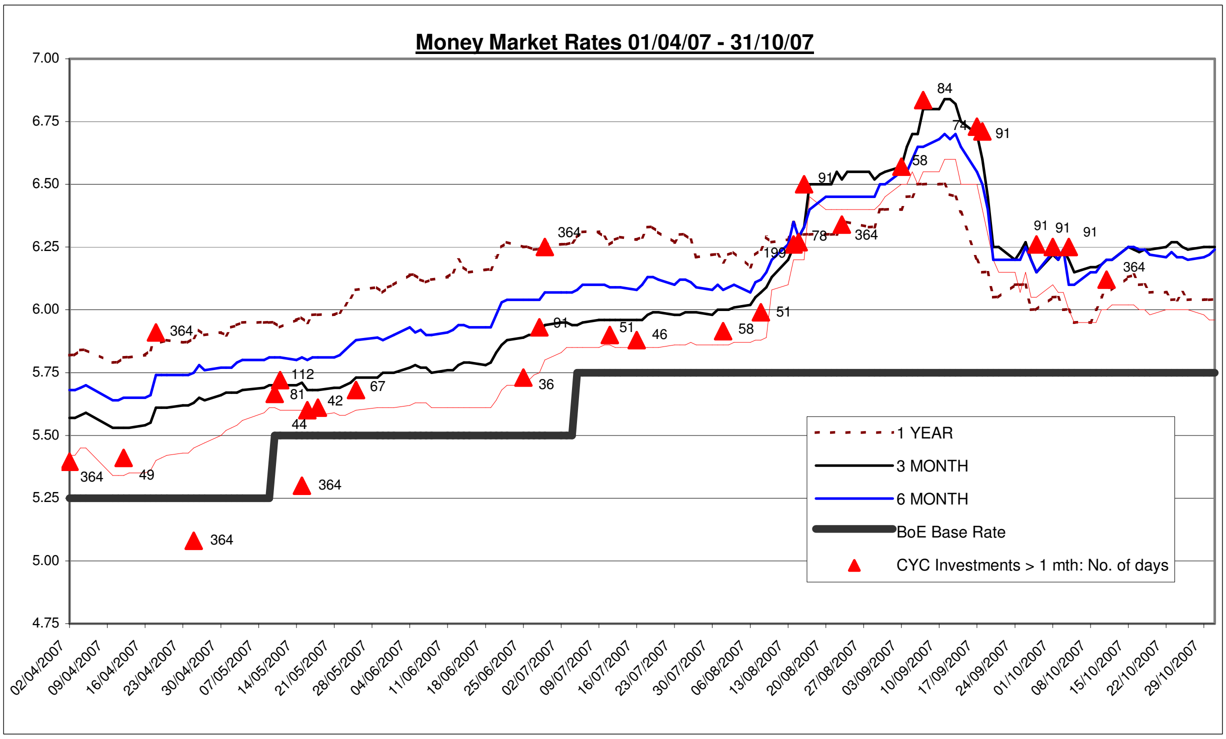

Figure 3 CYC Investments vs Money Market Rates

Long Term Borrowing

16. 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.

17. The Council's long term borrowing started the year at a level of £103.4m with no new loans being taken out or repaid to date. One loan of £4m with a fixed interest rate of 4.35% was repaid on 5 November. Figure 4 shows the PWLB rates (the grey area showing rates between 25 and 50 years) since April 2006 and when borrowing took place.

18. 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). During the current financial year the Council has set a trigger for long term borrowing of 4.25%. Long term borrowing rates started the year at a level of 4.45% and have since fluctuated for the first seven months of the year between 4.45% and 4.90%. The borrowing that took place in September and November 2006 illustrate this strategy and was taken in advance of

need. This means that the Council do not have to borrow in this financial year which also means an aggressive trigger point can be set.

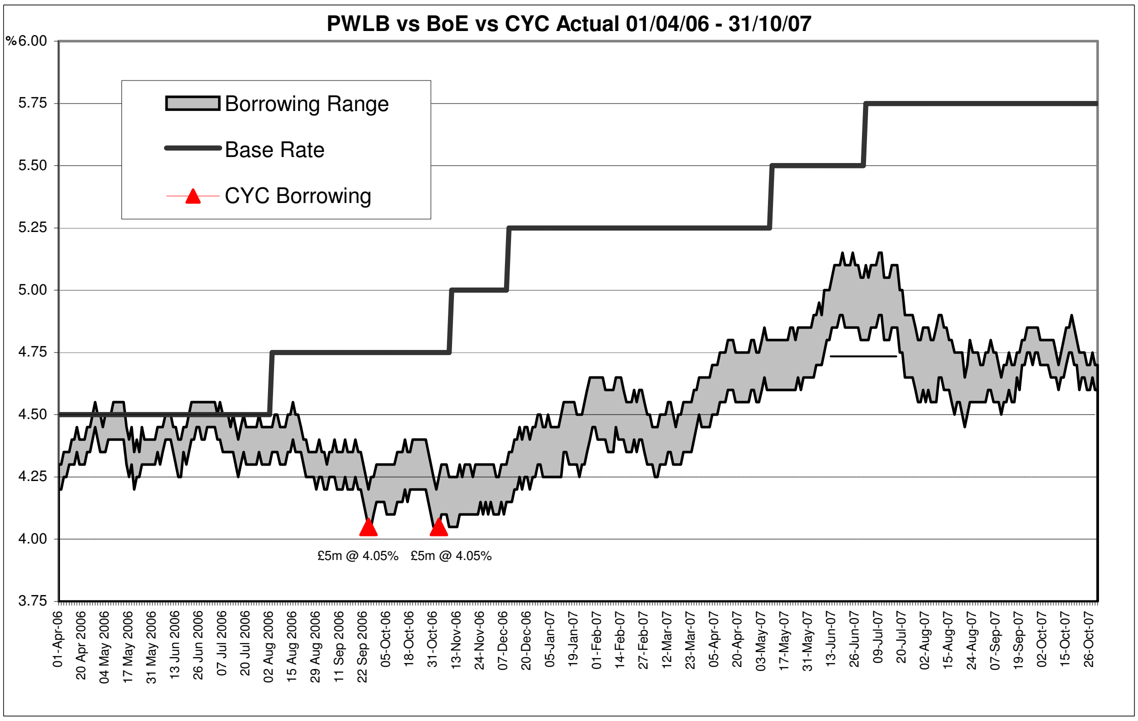

Figure 4 – PWLB rates vs CYC Borrowing Levels

19. Figure 5 illustrates the 2007/08 maturity profiles of the Council's debt portfolio.

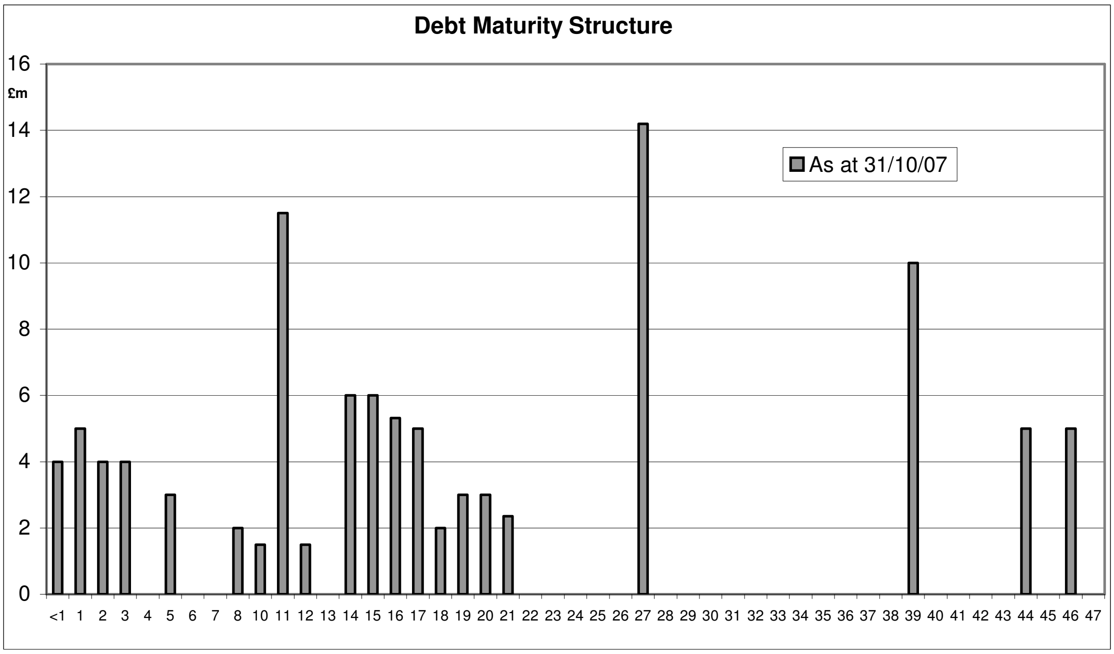

Figure 5 – Debt Maturity Profile 07/08

20. The average rate of interest on the Council's long term borrowing is 4.63%. This is 1.56% lower than the latest available average long term borrowing rate (source Sector 2005/06) for unitary authorities of 6.19%. Long term borrowing rates are expected to be around the 4.50 – 4.70% level for the latter part of 2007/08 having seen rates in the 45-50 year reach levels of 4.90% in the early stages of the financial year.

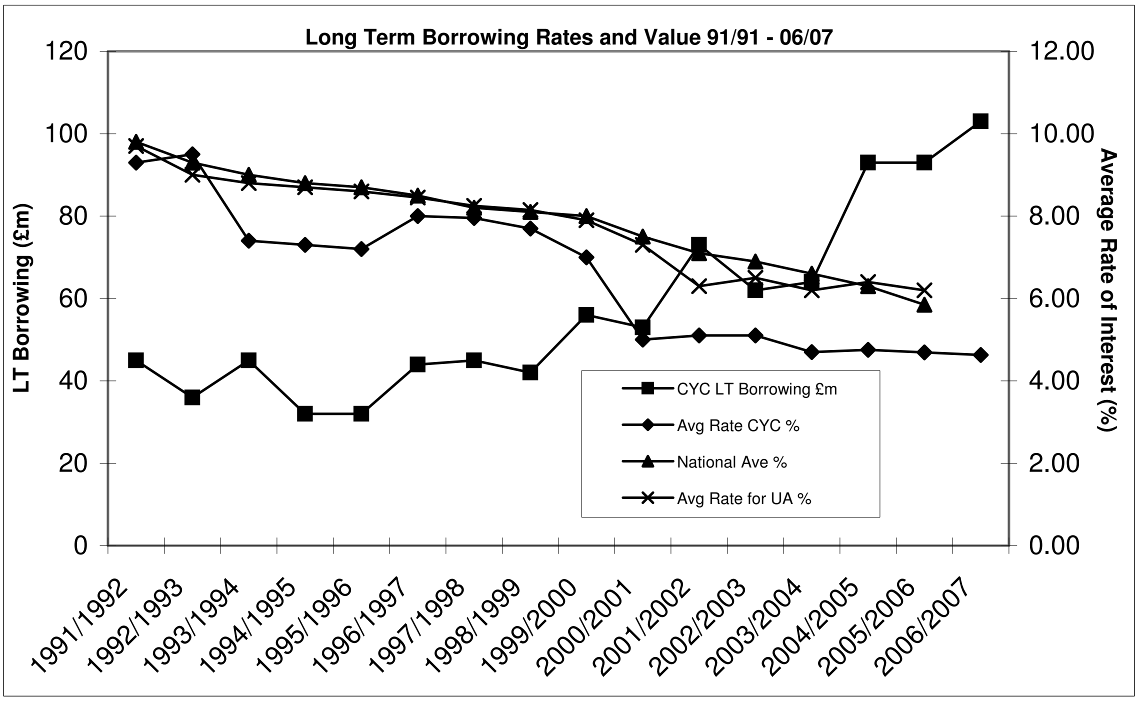

Figure 6 – CYC borrowing vs. National Average vs. Unitary Authority

Debt Restructuring

21. No debt restructures have taken place during the first seven months of the 2007/08 financial year. The Council continues to benefit from restructure made in previous years which have reduced significantly the average rate of interest on the Council's debt.

Venture Fund

22. 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 2007	**1,611**
New Loan Advances	(1,306)
Loan Repayments	1,611
Net Interest Received	(18)
Balance at 31st March 2008	**1,898**

Table 1 – Projected Venture Fund Movement 2007/08

23. Proposed loan advances for 2007/08 are £1,210k for Local Public Service Agreement 2 (a temporary loan until the government allocation is received) and £96k for Assets in Good Repair with repayments being received from a total of 10 schemes.

Treasury Management Budget

24. Treasury Management activity is contained within the Corporate Budget and has a current approved budget of £7,407k. The projected outturn is £5,651k resulting in a estimated under spend of £1,756k. Table 2 details the individual components that make up this under spend.

	(Under)/Over Spend £000
Delay in borrowing	(294)
Provision to repay debt	(44)
Increase in average balances	(872)
Increase in rate of interest	(423)
BCCI Dividend	(61)
Minor Budgets	(62)
Total Under spend	**(1,756)**

Table 2 – Treasury Management Budget 2007/08

25. The expected Treasury Management under spend is driven by the four main areas:
    a) The delay in borrowing is a result of PWLB borrowing interest rates (which are a reflection of yields on the UK Gilt market) remaining above the target level set at the start of each year. PWLB rates in the 45-50 year period have been at a low of 4.45% twice in this financial year,
    b) The increase in the rate of interest earned is due to the increase in the base rate and the higher than normal market interest rates, which were not forecast when the budget was set.
    c) The increase in average balances is attributable the capital and revenue underspends in 2006/07, the early payment of capital grants from central government, the early receipt of some capital receipts and projected slippage in capital expenditure in 2007/08.
    d) A £61k dividend payment from the liquidators of the collapsed Bank of Credit and Commerce International (BCCI) is due to be received this financial year, taking the total amount of debt recovered by the Council up to 90% (£1.4m) in sterling prices.

Review of the Prudential Indicators

26. In accordance with the Prudential code, the Prudential Indicators set by Council on 21 February 2007 must be reviewed. The Council remains within its prudential limits and full details of the indicators are given in Annex E, however, the key points are:

a) Size of the Capital Programme (Indicator 1) – The indicator set for the size of the 2007/08 Capital Programme was an estimate of £42.761m. Slippage from the 2006/07 financial year and additional spend on schemes in 2007/08 (as reported to The Executive in the Capital Programme Monitor 1 on the 9 October 2007) has increased the programme to a level of £52.525m.

b) Net Revenue Stream (Indicator 2) – This indicator represents how much borrowing the capital programme will cost as a percentage of the Council net budget. The General fund indicator is currently 4.28% compared to a level of 6.0% when the indicators were set. This decrease is attributable due to the high level of cash balances and a delay in borrowing. Both these factors reduce the net level of debt of the Council. The Housing Revenue Account (HRA) indicator for 2007/08 is 3.28% compared a budgeted figure of 3.31%.

c) Capital Financing Requirement (CFR) (Indicator 5) – The Council's CFR which represents the underlying need to borrow for capital expenditure purposes is £103m against a budget figure of £112m. The reduction is due the increased level of voluntary set-aside at the end of the 2006/07 financial year which was not included in the original budget. Voluntary set-aside can only be established once the capital programme has been financed at close down and was largely because of the sale of St Leonard's Place.

d) Authorised Limit / Operational Boundary (Indicator 6) – The Council's level of debt as at 31 October stands at £103.4m. No new borrowing has been taken during this financial year and the Councils debt remains within the level of £158.2m set at the budget.

Human Resources Implications

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

Equalities

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

Legal Implications

29. 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

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

Information Technology Implications

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

Property Implications

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

Risk Management

33. 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

34. Members are requested to:
    - Note the performance of the Treasury Management Activity;
    - Note the projected underspend of £1.756m;
    - Note the movements in the Prudential Indicators.

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

Contact Details

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Tom Wilkinson Corporate Finance Manager Tel No: 551187	**Report Approved**	✓	**Date**	27/11/07

Wards Affected: 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 , 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 – Money Markets Trading Statistics
- Annex D – Investments over 1 month in duration
- Annex E – Prudential Indicators 07/08