CITY OF YORK COUNCIL

Executive **16 February 2010**

Report of the Director of Resources

Treasury Management Monitor 3 and Prudential Indicators 09/10

Summary of Report

1. This report updates the Executive on the Treasury Management performance for the period 1 April 09 to 31 December 2009 compared against the budget presented to Council on 21 February 2009.

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

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

Background

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

4. The Council approved the Treasury Management Strategy, budget and Prudential Indicators on 21 February 2009. This report monitors the Treasury Management activity for the first nine months of 2009/10 and shows the change in the Treasury Management budget to 31 December 2009 and the forecast outturn position for the year.

Consultation

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

Corporate Priorities

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

Economic Background and Analysis

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

   a. The third quarter of the financial year of 2009 saw:
      i. Activity indicators suggest that the economy is finally exiting the recession
      ii. Household spending grow at its fastest rate since early 2008
      iii. The deterioration of the labour market slow considerably;
      iv. Little improvement in the UK's trade position;
      v. Monetary policy loosened again...
      vi. …but with only limited effect on asset markets and the growth of the money supply;
      vii. Inflation rise as higher energy costs pushed up the annual comparison;
      viii. Financial markets make further gains, but at a much slower pace;
      ix. International economies grow at a faster rate than the UK

   b. Monetary policy was loosened further in the fourth quarter. At its meeting in November, the Monetary Policy Committee (MPC) increased the amount of asset purchases under the Bank's Quantitative Easing (QE) programme by £25bn to £200bn. However, QE continued to have a relatively limited effect, and there were only tentative signs of a positive impact outside of financial markets.

   c. Household spending in Q3 looks set to have grown at its fastest rate since early 2008. The annual growth in retail sales was the highest in nearly eighteen months in October. Retail sales should have received at least some support towards the end of the year as consumers brought forward spending before the reinstatement of the standard rate of VAT on the 1st January.

   d. Q3 also saw the rate of deterioration in the labour market slow considerably. Unemployment claimant count rose by 5,900 in October but *fell* by 6,300 in November 2009.

   e. The improvement in the labour market no doubt supported the housing market, which continued to recover in the third quarter, albeit at a slightly slower rate than in Q2. The Nationwide house price index finished the quarter 1.5% higher than at the end of the previous quarter. The Halifax measure, which had been a little less buoyant in Q2, also posted decent rises. However, the rise in house prices continued to be largely driven by the shortage of homeowners putting their homes up for sale, suggesting that the rises may prove to be temporary.

f. Consumer Price Inflation (CPI) rose in the third quarter, from 1.1% in September to 1.5% in October and 1.9% in November, while RPI inflation returned to positive territory. Much of the rise in inflation was the result of energy price inflation turning from negative to positive.

g. The third quarter saw the global recovery continue to take hold. Once again, the recovery appeared to be strongest in the US. In the euro-zone, the output balance of the composite PMI index rose over the quarter to be consistent with quarterly growth in euro-zone GDP of around 0.5%. The recovery looked set to be strongest in France and Germany. But, like in the US, there were concerns that households in all countries remained reticent to spend.

h. Figure 1 shows the actual and projection of the base rate, which remains at historically low levels through much of 2010. The Council's treasury management advisers – Sector – forecast that the base will start to rise towards quarter 4 of 2010 and will gradually continue to increase on a regular basis to 2013. UBS also estimate a rise in the base rate from September 2010 but their forecast is slightly less aggressive than Sector, they believe growth will be slower throughout 2011 but there will be moderate economic recovery. Capital Economics remain pessimistic about economic recovery to the end of 2011 and they forecast the base rate to remain at 0.5%.

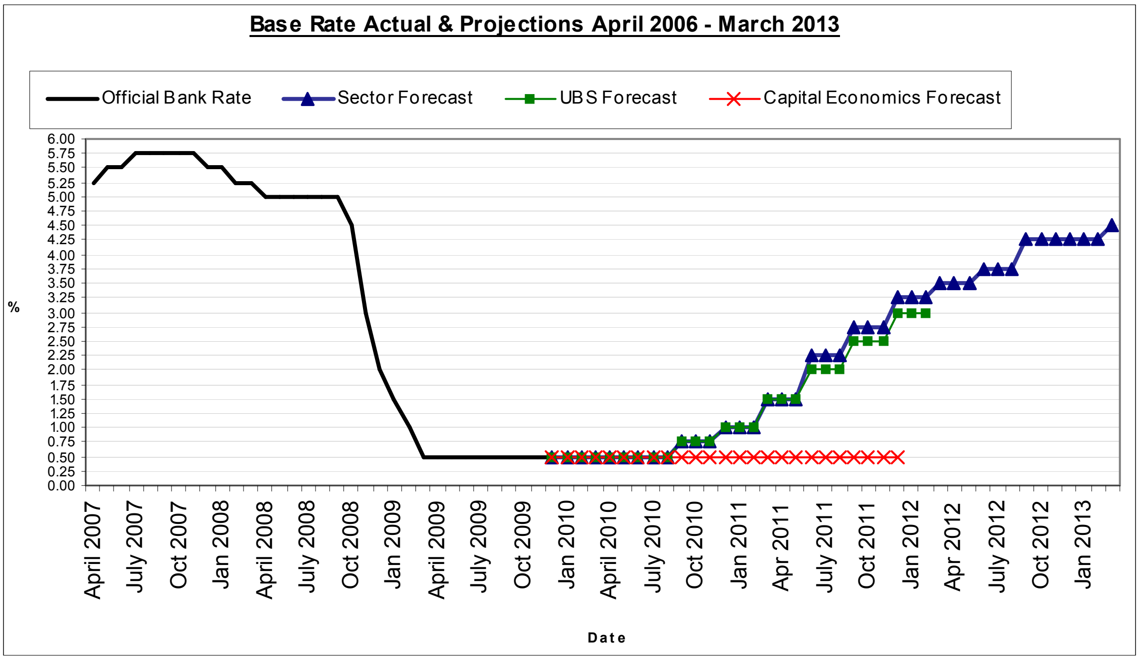

Figure 1: Base Rate 2006 to 2013 - latest forecast 23 November 2009

i. Table 1 provides the Council's Treasury Advisers, Sector, forecast of the base rate and Public Works Loan Board (PWLB) rates as at 23 November 2009:

	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Bank rate	0.50%	0.50%	0.75%	1.00%	1.50%	2.25%	2.75%	3.25%	3.50%	3.75%	4.25%	4.25%	4.50%
5yr PWLB rate	3.05%	3.20%	3.30%	3.40%	3.60%	3.85%	4.15%	4.55%	4.60%	4.80%	4.80%	4.85%	4.85%
10yr PWLB rate	4.00%	4.05%	4.15%	4.30%	4.45%	4.60%	4.80%	4.90%	5.00%	5.10%	5.10%	5.15%	5.15%
25yr PWLB rate	4.55%	4.65%	4.70%	4.80%	4.90%	5.00%	5.05%	5.10%	5.20%	5.30%	5.30%	5.35%	5.35%
50yr PWLB rate	4.60%	4.70%	4.75%	4.90%	5.00%	5.10%	5.15%	5.20%	5.30%	5.40%	5.40%	5.45%	5.45%

Table 1 – Sector's forecast interest rates as at 23 November 2009

j. With regard to long term borrowing, the Public Works Loan Board (PWLB) rates across all ranges are forecast to steadily increase, as seen in table 1, to reach 5.45% by the end of 2013. This is due to high gilt issuance, reversal of QE and investor concerns over inflation.

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

l. Investment rates fell at the beginning of the financial year with the 1 year rate starting at 2.15%. In September 2009 the 1 year rate was 1.10% and by December 2009 this rose slightly to 1.22%.

m. A number of large UK banks keen to accept Local Authority investments continue to offer competitive rates on call accounts paying 0.25% to 0.3% above the Bank of England base rate as a minimum. During the year to 31 December 2009, call accounts have been paying rates equivalent or higher than could be achieved through 1 to 2 months fixed term money market investments. In September call accounts were paying higher rates than 9-month market rates and in December 2009 call accounts were paying higher than 6 month market rates. The Council takes advantage of such accounts and currently actively operates 3 call accounts:
   i. Bank of Scotland instant access call account has been fixed at 0.25% above base during the period (0.75%).
   ii. Alliance and Leicester call account has been constant at 0.30% above base rate (0.80%).
   iii. Yorkshire Bank call account fixed at 0.30% above base rate (0.80%).

   During 2009/10, 3 call accounts have been in operation, which is 3 less than were available in 2008/09 due to the lower rates on offer and therefore no value is added to the investment portfolio.

Investment Policy

8. The Treasury Management Strategy Statement for 2009/10 was approved by Council on 21 February 2009. The Council's Annual Investment Strategy, which is incorporated in the Strategy, outlines the Council's investment priorities as follows:
    - Security of Capital
    - Liquidity

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

10. Investments held at 31 December 2009 in accordance with Sector's Creditworthiness matrices, and changes to Fitch and Moody's credit ratings remained within the Council's approved credit criteria limits contained in the Annual Investment Strategy.

Short Term Investments

11. Investment rates available in the market remain at an historical low point. The average level of funds available for investment purposes in the first nine months of 2009/10 was £43.357m. The level of funds available is largely dependent on the timing of the Council's cash flow as a result of precept payments, receipt of grants and progress on the Capital Programme. These funds are therefore available on a temporary basis dependant on cash flow movement. The average balance is lower than in previous years due to the timing of grants received in "advance of need" being shorter. The authority holds some core cash balances for investment purposes, i.e. funds available for a year or more, however in 09/10 no funds have been invested for periods greater than one year due to the limited institutions available for investment in accordance with the credit criteria policy.

12. Treasury Management investment activity during the first nine months earned interest £875k, equivalent to a 2.37% rate of return. This is 1.92% better than the average 7 day London Inter-Bank Deposit rate (LIBID) of 0.45% and 1.87% higher than the average base rate for the period of 0.50%. The high rate of return on investment activity compared to the average LIBID rate and base rate for the period is due to (a) locking into higher rates in 2008/09 for periods up to a year which had a positive affect on the average interest rate in 09/10 and (b) the treasury team continuing to monitor the market and taking advantage of longer term rates out to a year when they become available. The level of activity compared to the treasury management benchmark indicators above is positive, however the market interest rates in the 2009/10 year have been lower than anticipated.

13. Taking into account the direct cost of dealing, the in-house team is forecast to achieve a net trading surplus in 2009/10 of £959k. This will be equivalent to a return of 2.21%, which is 1.71% above the estimated average rate to be paid by the bank on credit balances held in the Council's main bank account. The bottom line added by the Council's money market trading activities taking off the direct cost of dealing is estimated at £742 for 2009/10.

14. The Council has made 16 investments via the money market brokers during the first 9 months of 2009/10. Of these 10 have been invested for periods of greater than one month. This is shown in Figure 2 below. In accordance with the Treasury Management Strategy investments have been kept short due to the low levels of interest rates available and the limited number of institutions in the market.

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

16. Figure 2 shows the interest rates achieved on investments of 3 months or more in comparison to the range of rates (between 1 month and 1 year) being offered on the money markets at the time investments were made. It shows the investment rates obtained are in line with the interest rates which are available when security of funds are of prime importance.

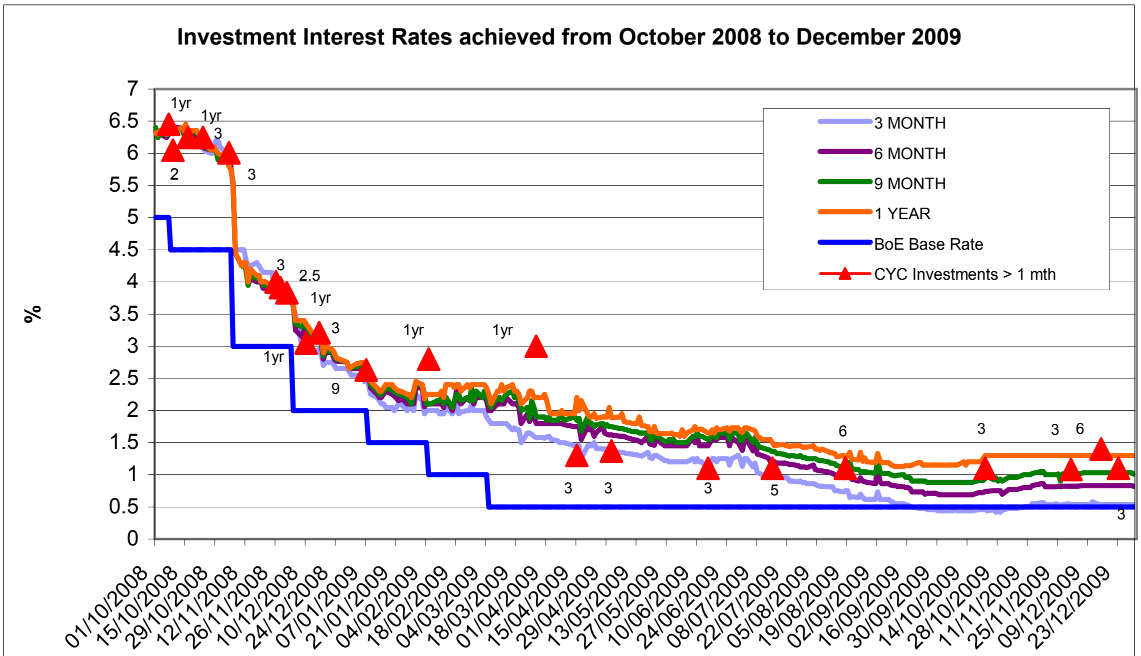

Figure 2 CYC Investments vs Money Market Rates

Long Term Borrowing

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

18. The level of borrowing taken by the Council is determined by the Capital Finance Requirement, (the Councils underlying need to borrow for capital expenditure purposes). The Capital Financing Requirement for 2009/10 is £118.9m, which gives a borrowing requirement of £21.1m. This is higher than originally expected at the beginning of the year due to Capital receipts not being realised, therefore being replaced by borrowing and approval by the Executive in Capital Monitor 2 for additional £3m borrowing to fund the capital programme.

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

20. The Councils long-term borrowing started the year at a level of £102.1m. One loan of £4m was duly repaid in May in line with its maturity date. New Borrowing totalling £15m has been taken to mid January 10, as follows:
    - £3m PWLB loan at 3.83% 10 years on 10 August 09
    - £3m PWLB loan at 3.59% 10 years on 8 October 2009
    - £3m PWLB loan at 3.91% 15 years on 13 October 2009
    - £2m PWLB loan at 3.36% 6 years on 15 January 2010
    - £2m PWLB loan at 3.64% 7 years on 15 January 2010
    - £2m PWLB loan at 3.87% 8 years on 15 January 2010

21. The loans taken in 2009/10 have been of fixed term duration and target periods that offer the best rates available. 45-50 year PWLB rates started the year at 4.57%. Rates have risen steadily up to a high of 4.85% at the beginning of June 09 with rates dropping back to the lowest level in 09/10 of 4.18% by mid October 09, only to rise back to 4.56% at 31 December 2010. All these rates are above the target-borrowing rate set for the year of 3.95%. The medium term PWLB 9-10 year rate started the year at 3.36% saw its highest point at 4.30% and by the end of December 2009 the rate was 4.29%.

22. For Quarter 2 and 3, the period of 10 to 15 years was identified as providing the best opportunity (a) for value for money as it is difficult to predict how the market will continue to move long term in the current environment and (b) the potential to reschedule the loan if required in future years. For quarter 4, the period of 5 to 10 years has provided the best rates available as forecasts continue to show that PWLB rates in all periods will rise in the next 2 years; this is illustrated in Table 1.

23. 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. Figure 3 shows the PWLB rates since April 2006 and details when new borrowing has taken place.

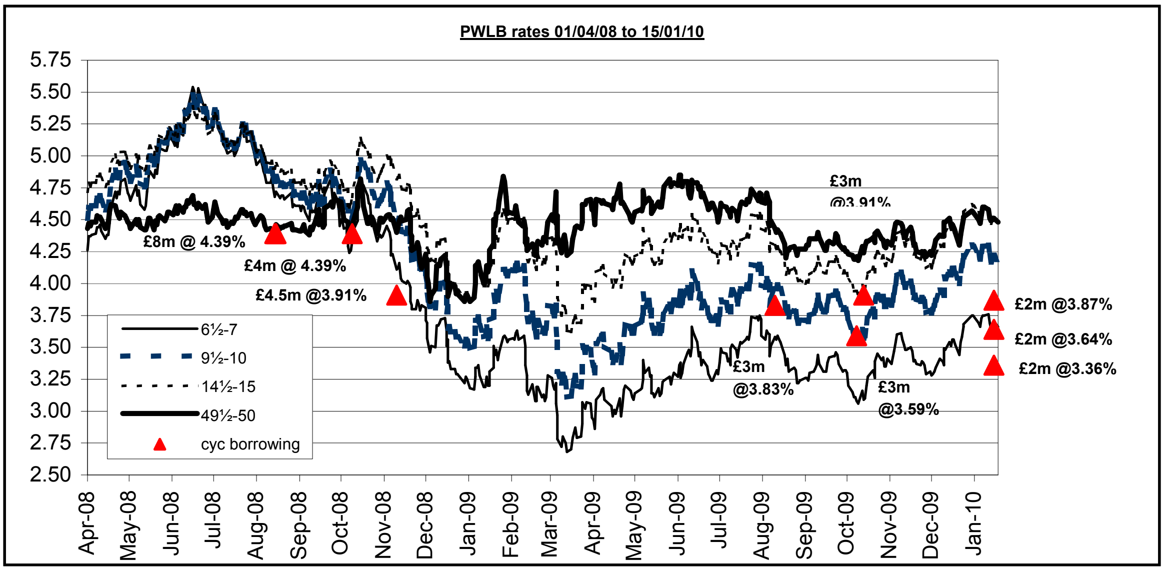

Figure 3 – PWLB rates vs CYC Borrowing Levels

24. Figure 4 illustrates the 2009/10 maturity profile of the Council's debt portfolio updated to reflect the borrowing this year. The borrowing portfolio totals £113.1m and the maturity profile shows that there is no large concentration of loan maturity, thereby spreading the interest rate risk dependency in any one year.

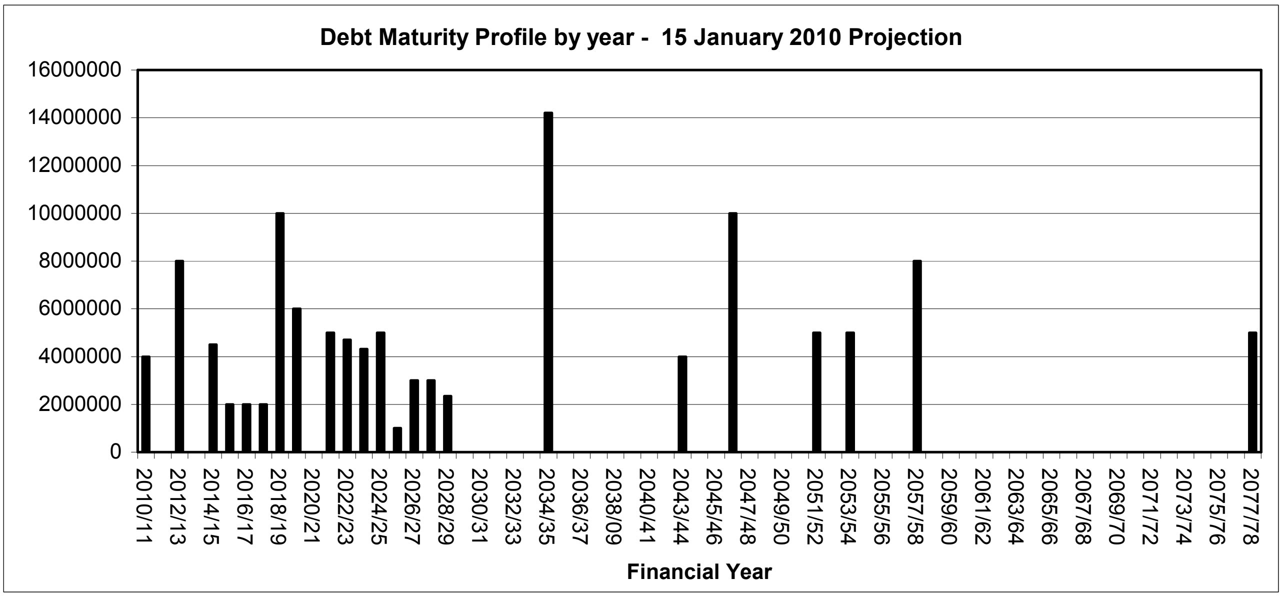

Figure 4 – Debt Maturity Profile 09/10

Venture Fund

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

	£'000
Balance at 1st April 2009	**2,275**
New Loan Advances	(785)
Loan Repayments	678
Net Interest Received	18
Balance at 31st March 2010	**2,186**

Table 2 – Projected Venture Fund Movement 2009/10

26. The position of the Venture Fund has changed since Monitor 2. As mentioned in the Capital programme Monitor 2, £35k loan was approved for the Peckitt Street flood defences by the Director of Resources under delegated approval. Total loan advances for 2009/10 stands at £785k and also includes £650k for the easy programme which reflects funding required for internal resources associated with the transformation programme – More for York - work and £100k for the street lighting capital scheme approved by Council on 21 February 2009. The easy programme loan is a prudent estimate of the amount, which will potentially be required by year-end. 7 schemes contribute to loan repayments of which five will be completed at the end of 2009/10.

Treasury Management Budget

27. Treasury Management activity had a Corporate Budget approved at Council on 21 February 2009 of £7,727k. In August 2009, the current approved budget was £8,557k. In the Monitor 3 Revenue Budget report, approval from Members is requested to increase the treasury management budget by £124k to £8,681k. The projected outturn is £9,110k resulting in an estimated overspend of £429k. Table 3 details the individual components that make up this overspend.

	(Under)/Over Spend £000
Increase in financing expenditure (interest paid)	13
Provision to repay debt	0
Decrease in interest receivable	416
Total Overspend	**429**

Table 3 – Treasury Management Budget 2009/10

28. The expected Treasury Management budget overspend has reduced by £100k from Monitor 2 to £429k. Action has been taken to mitigate the overspend as there has been a change in the way that part of the capital programme is to be funded; a direct revenue contribution from LCCS has been changed to prudential borrowing. Although the actual cost to treasury management increases by the finance costs of the prudential borrowing, the treasury management budget has increased by £124k thereby reducing the overall Treasury Management budget overspend by £100k to £429k.

29. In accordance with Financial Regulations, approval has been requested in the Revenue Monitor 3 report for a virement of £124k from LCCS to Treasury Management, this being the total amount of the LCCS Revenue Contribution plus financing costs.

30. The breakdown of the overspend is weighted towards an under recovery of income from interest received.

    a. The increase in interest paid is only slightly above that which was budgeted due to the volatility of the market and the timing of loans taken.
    b. The decrease in interest receivable is due to the continued fall in market interest rates available for investment with the 1-year rate starting the year at 2.15% and continuing to fall to 1.15%. There are lower cash balances than originally anticipated; therefore the majority of cash is being invested in line with cash flow requirements.

31. As reported in Monitor 2, it is expected that growth will continue to be slow in 2010/11, resulting in continued lower market interest rates being available for investments. This is evidenced by the increased quantitative easing announced by the Bank of England in November by £25bn to £200bn. Lower interest rates on investments will therefore be earned for the

foreseeable future. This is compounded by the prudent Council's approved credit criteria limits set for the security of funds, which reduces the favourable interest rates available for investment.

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

Prudential Indicators Update

33. It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits". Council's approved Prudential Indicators (affordability limits) are outlined in the approved Treasury Management Strategy. Prudential Indicators are attached at Annex A. Prudential Indicators were not breached during the first 9 months of 2009/10.

Human Resources Implications

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

Equalities

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

Legal Implications

36. 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

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

Information Technology Implications

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

Property Implications

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

Risk Management

40. 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

41. Members are requested to:
    - Note the performance of the treasury management activity;
    - Note the projected overspend of the treasury management budget of £429k.

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

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 09/10, Investment Register 09/10, PWLB Debt Register, Capital Financing Requirement 09/10, Venture Fund 09/10, Statistics 09/10.

Annexes

Annex A – Prudential Indicators