Agenda Item: ?

CABINET

Annual Treasury Management Report 2008/09
28 July 2009

Report of Head of Financial Services

PURPOSE OF REPORT					
This report sets out the performance of the Council in respect of Treasury Management for 2008/09 and gives details of the activities undertaken during the year.					
Key Decision		**Non-Key Decision**		**Referral from Statutory Officer**	**X**
This report is public.					

RECOMMENDATIONS OF OFFICER

That the report be noted and referred on to Council for information.

1 **Introduction**

1.1 The Council's Treasury Management Strategy for 2008/09 was approved by Council on 27 February 2008. This report sets out the related performance of the treasury function by providing details of:

a) long term and short term borrowing (i.e. debt that the Council *owes*)
b) investment activities
c) relevant borrowing limits and prudential indicators.

It is a requirement of the CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice on Treasury Management in Local Authorities that such a report be made to the Cabinet within six months of the end of the financial year, and that it also be reported to Council for information.

1.2 The aim of the Treasury Management Policy and associated activity is to secure the most favourable overall position for the Council, i.e. by maximising the investment interest earned on surplus cash balances and minimising debt charges payable, whilst maintaining an acceptable and measured level of risk, e.g. on security of investments, etc. Clearly this has been (and continues to be) under much scrutiny, both locally and nationally, as part of the various reviews that have been undertaken in light of the Icelandic banking collapse.

1.3 One of the difficulties recognised in such reviews is that treasury management is a technical area. Training has been provided in the past, and undoubtedly it is expected to feature strongly in any new guidance or regulations issued. For now though, the usual glossary of terms commonly used in Treasury Management is attached at ***Appendix A***. In addition, the Councillor's Guide to Local Government Finance also has a section on treasury and cash management, and this is available through the Member Information section on the Intranet.

2 Summary: Headline Messages for 2008/09

2.1 The key points arising from this report are as follows:

- The Council has £6M of investments at risk, tied up with the collapse of the Icelandic banking sector. CIPFA has published information indicating recovery prospects of 100% from Glitnir (£3M invested), 95% from Landsbanki (£1M invested) and at least 50% from KSF (£2M invested). Before adjusting for interest and the timing of payments, these rates would lead to a return of £4.95M from the £6M invested. Definitive statements from the Administrators are still awaited, however. Prospects could alter significantly – but in any event they are likely to fluctuate.

- The Council has not breached any Treasury Management Prudential Indicators relating to debt in the year. Borrowings were in line with the Council's Capital Financing Requirement (CFR), they have not been above either the Operational or Authorised limits and the maturity profile/variable rate exposure on borrowings has also stayed within the approved limits.

- The Council has stayed within its Prudential limits for long term investments although it did have one breach of counterparty limits back in December. No losses were incurred as a result of this and new controls have been put in place to limit the risk of re-occurrence.

- The Council repaid PWLB loans in the year of £5.6M, saving £42K in year with recurring annual savings estimated at £251K. £8.5M of temporary borrowing was required at the end of the year, costing £5K in interest.

- Investment outturn was £803K, which was £200K below budget. This is mainly due to the impact of Icelandic investments in line with recent accounting guidance, but it was also due to the reduction of interest rates seen in last third of 2008/09. The Council's average rate of return is comparable with the base rate etc. over the year.

3 Icelandic Investments

During the year the Council had £6M invested in Icelandic banks. These assets are currently frozen, whilst Administrators calculate the returns to creditors. CIPFA has recently issued accounting guidance, which gives details of possible rates of return. These have been used as the basis for the year end entries in the 2008/9 accounts. In summary:

Bank	Return	Timing of payment
KSF (£2M)	At least 50% of principal and interest accrued up to 7/10/08.	10% expected July 2009, further payments spread evenly up to October 2012.
Glitnir (£3M)	100% of principal and interest up to 14/11/08 for priority creditors.	All payable March 2010
Landsbanki (£1M)	Between 95% of principal and interest payable up to 14/11/08 for priority creditors.	Payable in instalments up to December 2012.

Using these figures, the Council has "impaired" its Icelandic assets by £1.6M. This, however, takes into account the interest accrued on these investments, as well as the timing of repayments. On a simple cash basis, using the figures published by CIPFA, the Council should expect to get back at least £4.95M of the £6M invested. Definitive statements from the Administrators are still awaited, however.

4 Borrowing

4.1 Longer Term Borrowing and Funding of Capital.

Long term borrowing is an important part of the Council's capital financing. Under the Prudential Code a key indicator is the Capital Financing Requirement (CFR). This figure is calculated from the Council's balance sheet and represents, in broad terms, the gap between the value of fixed assets and that of capital reserves. In essence, this gap may be viewed as the cumulative amount of capital investment that may need to be funded through external borrowing (i.e. the amount of capital investment that hasn't been funded from other sources). Borrowing should not then exceed the CFR on a long term basis, as this could indicate that borrowing is being used to fund expenditure other than capital. For 2008/09 the figures were as follows:

	£000
Opening CFR	45,595
Closing CFR	45,857
Average CFR	**45,726**
Weighted average borrowings	44,752
Weighted average investments	20,565
Net borrowings	**24,187**

From this it is clear that net borrowings are well below the Council's CFR, and average gross borrowings are in line with it. This supports the reported position, i.e. that long term borrowing has not been used to fund revenue activities.

In addition, other indicators are set to control the absolute amount of debt (the Authorised limit) and expected gross debt but allowing for day to day cash management (Operational Boundary). Even though the Council needed to take on additional borrowing to cover the £3M of Icelandic investments not returned by

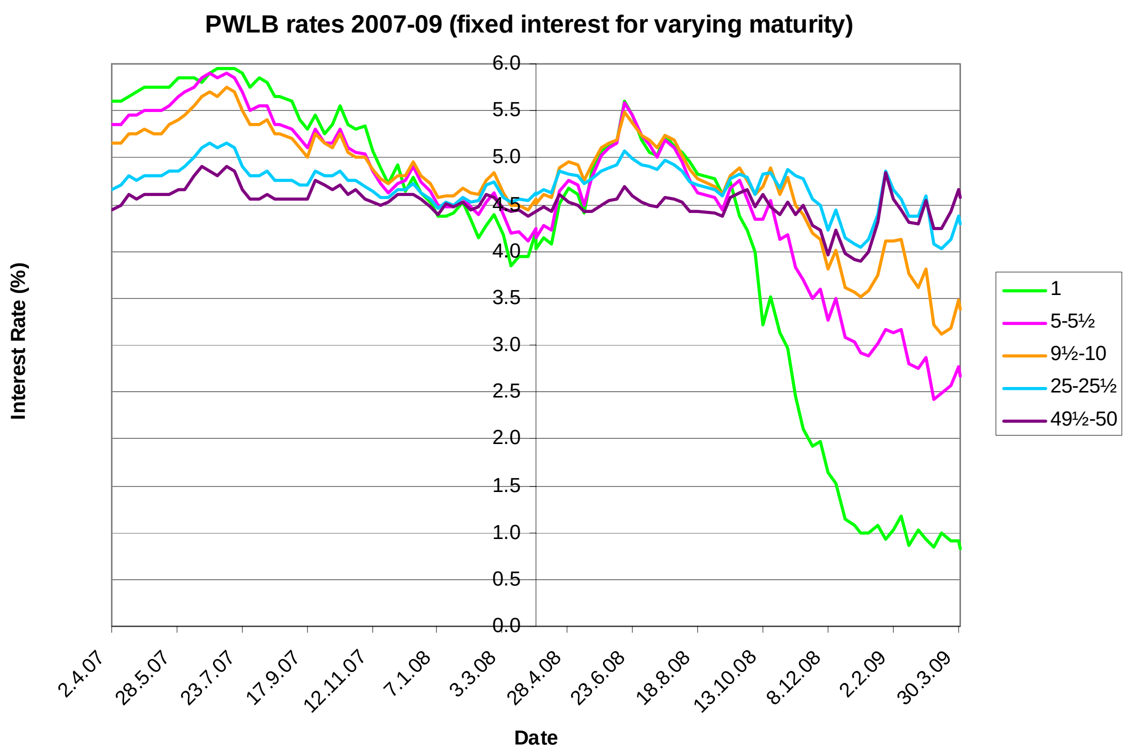
Glitnir, the Council has operated well within the set boundaries. Below is the year end position:

	Actual Debt 31/3/2009	Operational Boundary	Authorised Limit
	£000's	**£000's**	**£000's**
Deferred Liabilities	223	-	310
PWLB Debt	39,215	-	56,290
Temporary borrowings	8,500		
Total	47,938	49,100	56,600

It can be seen that the Council was £8.66M below the Authorised Limit and also £1.16M below the Operation Boundary. The year end was also the point at which the Authority was most indebted during 2008/09, due to the scheduled reduction of local tax income receipts in February and March. (Instalments are due over the period from April to January, and so income tails off in the last two months of the year).

4.2 PWLB Interest Rate Movements

All of the Council's long term borrowings are held with the Public Works Loan Board (PWLB). During the course of 2008/09 there has been a significant change in the interest rates over the different lengths of loan offered by the PWLB. Long term loans have remained at around 4.5%, with some volatility in the final third of 2008/09. Short term loans have changed markedly, however, with rates for loans of 1 year falling from 6% at their peak in 2007/08, to 1% at the end of 2008/09.



Repayment of PWLB debt is an attractive option in the current climate; this is because investment returns are far lower than the interest payable on exiting debt. However, early repayment of PWLB debt may subject to additional charges (known as premiums), and these must be taken account of accordingly. Allowing for these factors, the Authority repaid £5.6M of PWLB loans in January 2009. Any further opportunities for repaying debt early will be monitored through 2009/10.

4.3 Debt Maturity (or Repayment) Profile

The Council is exposed to “liquidity” risks if high value loans mature (i.e. become due for repayment) at the same time, making a large demand on cash. One Prudential Indicator which is used to manage this risk is the maturity structure of borrowing. This indicator introduces limits to help reduce the Council’s exposure to large fixed rate sums falling due for repayment (and potentially re-financing) all at once. The table below shows these profiles at the beginning, middle and end of the year against the indicator.

The movement in profile is due to the repayment of £5.6M of PWLB debt in January 2009. This was done to save interest costs but this cash had to be replaced by temporary loans, at least for a time. These temporary loans will be repaid as fixed term investments mature, with the net position being an overall reduction in both debt and investment balances. This position is preferable, given current concerns over counterparty risk and that prevailing investment returns are well below the interest rates payable on the Council’s loan portfolio.

None of the Council’s current longer term borrowing is due for scheduled repayment in the next ten years although, as discussed above, further early repayments could be made, depending on circumstances.

	Prudential Indicator	**Actual 31/3/08**	**Actual 31/9/08**	**Actual 31/3/09**
Under 12 months	0-35 %	0%	0%	18%
12 – 24 Months	0 - 5%	0%	0%	0%
24 – 5 years	0 – 10%	0%	0%	0%
5 – 10 years	0 – 20%	0%	0%	0%
10 years above	60 – 100%	100%	100%	82%

4.4 Interest Payable on Longer Term Borrowing

The average rate of interest payable on PWLB debt in 2008/09 was 5.56%, which was identical to 2007/08. However, the cost of long term borrowing showed a favourable variance against the revised budget:

	£’000
2008/09 Estimate	2,478
2008/09 Actual	2,436 (of which £837K was charged to the HRA)
Variance	42 (favourable)

The variance is due to the repayment of loans in January, saving 4.5% on £5.6M of loans for 2 months, with an ongoing annual saving currently estimated at £251K per annum.

As investment rates are not expected to improve markedly over the next 12 months (projected rate for 12 month fixed term deposit in March 2010 = 1.6%, source: Butler’s), Officers will continue to look for opportunities to repay debt rather than invest surplus cash.

All the interest payable was in relation to fixed interest loans. Prudential Indicators also provide exposure limits that identify the maximum limit for variable / fixed interest rate exposure, based upon the debt position. The table below shows that the outturn position was within the limits set by Members at the beginning of the year. The Council currently only has fixed interest rate maturity debt, although again this could change in future if market conditions warrant or facilitate it.

	Prudential Indicator	**Actual**
	%	**%**
Fixed Rate	100	100
Variable Rate	30	0

As yet there is no information available for last year with which to compare performance with other local authorities.

5 Shorter Term Borrowing (to support cash flow)

During 2008/09 some short term borrowing was required to support the Council's cash position toward the end of the year. As mentioned earlier, this need was influenced by the decision to repay PWLB loans early, and to cover £3M of Icelandic bank deposits that were due back in January. The interest cost of the loans (£5K) was more than offset by the savings on PWLB loans.

6 Investment Activities

6.1 Performance against Prudential Indicators

In 2008/009 all investments were placed in accordance with the approved Investment Strategy. There was one breach, however, when the Abbey National tried to return an investment to the Council's old Barclays current account. When Barclays returned this directly to the Abbey National, the counterparty limit as set down in the approved Investment Strategy for 0809 was breached by £900K for 6 days. This was the only breach during the year; no loss resulted from it and additional control procedures were put in place to mitigate the risk of this happening again. This incident was reported in the Qtr 3 treasury monitoring report.

From the start of 2008/09, the Council had only 1 investment due to mature 365 days or more from any point in the year. This was the £1M investment with Landsbanki, which was taken out in May 2007 for a 2 year period. Although this was well within the approved Performance Indicator limit of £6M, clearly ultimately the bank involved defaulted. For the last half of 2008/09, the Council shortened its investment periods significantly, in light of current economic conditions.

A full list of fixed investments is enclosed at ***Appendix B***.

6.2 Performance against budget and external benchmarks.

Interest earned in the year can be summarised as follows:

Interest earned	£803K (£203K of which was credited to the HRA)
Revised budget	£1,003K.
Variance	£200K adverse

This figure is lower than that reported for the end of Quarter 4, as in effect all Icelandic bank interest has been stripped out. This is in line with the accounting guidance as mentioned earlier.

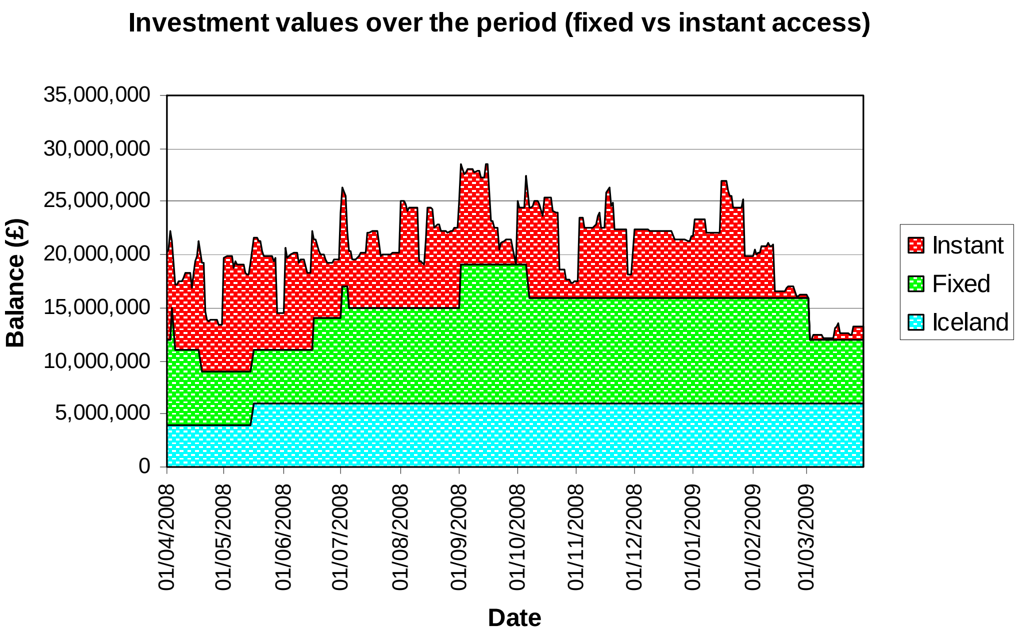
In terms of performance against external benchmarks, our investment returns can be summarised as follows:

Base Rate	3.61%
3 Month LIBID	4.59%
Lancaster CC investments*	3.91%
Lancaster CC investment 0708	5.82%

*This rate includes £6M frozen in Icelandic banks, but assumes they are not generating any interest.

Overall, the investment returns were within the range limited by the base rate and LIBID (London Inter-bank Bid) rate. In comparison to the prior year, there is a marked drop in the returns, which reflects the changes in the global economic conditions. It is anticipated that the returns for 2009/10 will be lower still, as the full impact of investment rate reductions is felt.

Following the Icelandic banking crisis, the approach to investing changed markedly. As can be seen from the chart below, no new fixed term investments were placed after 08 October 2008 and Officers chose to repay £5.6M of debt towards the end of the year, rather than invest cash. This reduced counterparty risk and saved interest charges. The Investment Strategy for 2009/10 approved in February formalised a much more conservative approach to managing surplus cash.



Similar to the borrowing comparators, there is currently no information available regarding other Local Authorities' investment performance during 2008/09.

7 Other Risk Management Issues

Many of the risks in relation to treasury management are managed through the setting and monitoring performance against the relevant Prudential Indicators, as discussed above. There is also liquidity risk associated with accessing cash when it is needed, on a day to day basis, but for a local authority this is not judged as significant.

At a higher level though, the main focus and perception of risk within treasury management has changed over the year. The position has changed from a relatively stable economy with investment returns that were higher than the cost of much of the Council's debt, to one where investment returns have slumped and the credit worthiness of counterparties is paramount. The Authority's Investment Strategy is designed to engineer risk management into investment activity largely by reference to credit ratings and length of deposit, together with supporting advice. This strategy is required under the CIPFA Treasury Management Code, the adoption of which is another Prudential Indicator.

From the various national reviews undertaken so far, it is clear that there will be many changes to the treasury management framework in future, for all concerned – Officers, Members, Auditors, Consultants, and bodies such as CIPFA.

8 Other Prudential Indicators

As required under the Prudential Code, certain other year end Prudential Indicators must be calculated and these are included elsewhere on the agenda, as part of the 2008/09 Outturn report. These will be incorporated into the referral report to Council.

9 Details of Consultation

Officers have consulted regularly throughout the year with Butlers, the Council's Treasury Management consultants.

10 Options and Options Analysis (including risk assessment)

There are no options available to Members as such; reporting of activities to both Cabinet and Council is required under Treasury Management Code of Practice and reflected in the Council's Strategy.

11 Officer Preferred Option and Comments

Not applicable.

12 Conclusion

It is clear, given the Icelandic position, that the overall aim of treasury management policy, i.e. "to secure the most favourable overall position for the Council", has not been achieved in 2008/09. Work will continue to secure the best returns possible from Icelandic investments, and to help ensure that the policy aims can be achieved once again, in 2009/10 and beyond. This includes meeting any new requirements as may be implemented over the coming months.

RELATIONSHIP TO POLICY FRAMEWORK
This report is in accordance with the Council's Treasury Management Policy Statement.

CONCLUSION OF IMPACT ASSESSMENT
(including Diversity, Human Rights, Community Safety, Sustainability, etc)
No direct implications.

FINANCIAL IMPLICATIONS
As set out in the report. These have also been incorporated into the outturn for 2008/09, as included elsewhere on the agenda.

DEPUTY SECTION 151 OFFICER'S COMMENTS
The Deputy Section 151 Officer has been consulted and has no comments to add.

LEGAL IMPLICATIONS
Legal Services have been consulted and have no comments to add.

MONITORING OFFICER'S COMMENTS
The Monitoring Officer has been consulted and has no comments to add.

BACKGROUND PAPERS **Treasury Management Strategy and Policy documents 2008/09.**	**Contact Officer: Pete Notley** **Telephone: 01524 582567** **E-mail: pnotley@lancaster.gov.uk**