Herefordshire Council

APPENDIX 1

TREASURY MANAGEMENT REPORT 2008/09

PURPOSE

The purpose of this report is to advise Cabinet of the Council's treasury management activities during 2008/09.

1. INTRODUCTION AND BACKGROUND

1.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice on Treasury Management 2001 was adopted by the Council in February 2002 and the Council fully complies with its requirements. The primary requirements of the Code are the:-

a. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the council's treasury management activities.

b. Creation and maintenance of Treasury Management Practices which set out the manner in which the council will seek to achieve those policies and objectives.

c. Receipt by the Cabinet of an annual treasury management strategy report for the year ahead and an annual review report of the previous year.

d. Delegation by the council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

1.2 Treasury management in this context is defined as:

"The management of the local authority's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. "

1.3 The authority's treasury management activities expose it to a variety of financial risks:

a. Credit risk: The possibility that other parties might fail to pay amounts to the council.

b. Liquidity risk: The possibility that the council might not have funds available to meet its commitments to make payments.

c. Market risk: The possibility that financial loss might arise for the council as a result of changes in such measures as interest rates.

The Council, in adopting the CIPFA Code of Practice on Treasury Management to produce its annual Treasury Management Strategy, has operated within a control framework to minimise risks relating to financial instruments.

1.4 An internal audit review in February 2009 concluded that the monitoring and control of the treasury management system is **good**.

1.5 This annual treasury report covers:

a. the Council's borrowing transactions 2008/09.

b. the Council's investment transactions 2008/09.

c. the outturn position 2008/09.

d. the strategy for 2008/09.

e. the economy in 2008/09 (borrowing and investment rates in 2008/09).

f. compliance with treasury limits and Prudential Indicators.

1.6 Effective treasury management can make a useful contribution to helping achieve the council's strategic objectives.

2. THE COUNCIL'S BORROWING TRANSACTIONS 2008/09

2.1 The following summary gives information relating to the Council's borrowing transactions in 2008/09.

Borrowing Summary	£	£
Long-term Borrowing		
As at 1st April 2008	105,888,614	
New Borrowing (see paragraph 2.3)	10,000,000	
Less: Repayments	(485,952)	
As at 31st March 2009		**115,402,662**
Short-term Borrowing (see 2.8)		
As at 1st April 2008	0	
New Borrowing (see paragraph 2.3)	3,000,000	
As at 31st March 2009		**3,000,000**
Total Borrowing as at 31st March 2009		**118,402,662**

2.2 The Public Works Loan Board (PWLB) remains the main source of long-term borrowing for the Council. In addition to PWLB loans the council has two LOBO (Lender Option, Borrowing Option) loans totalling £12m.

2.3 After careful consideration of interest rate forecasts, expected capital spending, repayment profile and having regard to the existing debt, additional long-term loans were taken during 2008/09 as follows:

Date	Loan Type	Lender	Amount £	Period (years)	Interest Rate %
10/09/08	Fixed Maturity	PWLB	5,000,000	50	4.38
09/10/08	Fixed Maturity	PWLB	5,000,000	50	4.36
			10,000,000		

2.4 As comparative performance indicators, average PWLB maturity loan interest rates for 2008/09 were:

Period (years)	Interest Rate %
1 year	3.26
9.5 - 10 years	4.48
24.5 - 25 years	4.57
49.5 - 50 years	4.44

2.5 The average rate of interest paid on borrowings during the year was 4.44% compared to 4.50% in 2007/08.

2.6 The long-term debt at 31st March 2009 falls due for repayment as follows:

Long-term Debt Profile **Within**	**£**	**% of total debt**
1 year	12,255,361	11
1 – 5 years	3,618,066	3
5 – 10 years	1,897,225	2
10 – 15 years	8,288,626	7
15 years and over	89,343,384	77
TOTAL	**115,402,662**	**100**

2.7 Included in the debt repayable within one year are two LOBO loans for £6 million each which were taken out in 2004. Interest is payable at 4.50%, however, every year on the anniversary of taking out each loan the lender has the option to raise the interest rate payable. If this option is exercised the Council may repay the loans. If the interest rate remains unchanged the loans could remain on the balance sheet until 2054.

2.8 In March 2009 the Council borrowed £3 million from West Sussex County Council for 33 days at an interest rate of 0.60%. The loan was taken out at an advantageous interest rate to ensure that the Council had sufficient liquid balances to meet its day to day requirements.

2.9 In addition to the external borrowing identified above, the Council has a bank overdraft facility with its bankers, National Westminster Bank plc, of £6,000,000, which was used on a limited basis during the year. This was used in preference to short-term borrowing of amounts less than £100,000 where it would not be cost effective to borrow through the money market.

2.10 The Council has twelve accounts with National Westminster Bank but it has an arrangement whereby the balances on the accounts are offset. When the overall balance is in credit the Council does not receive any interest but when the balance is overdrawn the Council pays interest at a rate of 1% over the Bank Base Rate.

2.11 The Council's aim is to maintain a nil net cleared balance, as far as possible, on its accounts at National Westminster Bank. In practice this is hard to achieve because some receipts are credited directly to the bank. However, such sums are not significant in overall terms. On ten occasions during the year the net cleared balance was either more than £100,000 in credit or more than £100,000 overdrawn. Excluding these occasions, the average daily bank balance for 2008/09 was £9,526 in credit. **Annex A** illustrates the balances for 2008/09.

3. THE COUNCIL'S INVESTMENT TRANSACTIONS 2008/09

3.1 All investments are managed internally using the institutions listed in the Council's approved lending list.

3.2 The Council manages its in-house investments with the institutions listed in the Council's approved lending list. The Council placed investments for a range of periods from overnight to 364 days. The length has always depended on factors such as cash flow requirements, and if it was viewed that interest rates would change, but this year the uncertainty in the financial markets was also a major factor.

3.3 In the second half of the year many of the banks and building societies were given a "negative outlook" by the credit rating agencies and so the Council stopped investing with them. In addition the decision was taken to only use UK institutions where the situation could be monitored more closely. As a result by the year end the Council had very few eligible counterparties and started using the UK government's Debt Management Office (DMO). Use of the Debt Management Office is risk-free but the interest rate paid is relatively low (below the Bank Base Rate).

3.4 During the year the daily interest rate earned on investments varied between 1.48% (March 2009) to 5.76% (April 2008) with the total daily amount invested averaging £52,509,249. The total invested ranged from £23,560,000 (towards the end of the year) to £68,950,000 (in October 2008), which illustrates how much the temporary cash flow fluctuates throughout the year. The temporary short-term investment transactions for 2008/09 are summarised as follows:

Internally Managed Investments	**£**	**£**
As at 31st March 2008		41,130,000
Investments made during year (265 transactions)	1,915,042,534	
Less: Investments recalled during year	1,929,742,534	(14,700,000)
As at 31st March 2009		**26,430,000**

3.5 The average interest rate achieved was 4.71%, which compares favourably with the generally accepted benchmark of the average 7-Day London Inter-Bank Bid (LIBID) rate of 3.60%. The Bank of England Bank Rate decreased from 5.00% at the start of the year to 0.50% at the end of the year.

3.6 **Annex B** compares the monthly average interest rate earned on internally managed funds, the 7-day LIBID rate, borrowing rates offered by the PWLB and the Bank of England Base Rate.

3.7 The following table summarises the investment income received in 2008/09:

Summary of Investment Income	£	£
Internally Managed Funds		2,479,078
Less: transfers to Schools	(99,659)	
Interest payments to trusts etc.	(165,677)	
		(265,336)
Interest Received 2008/09		**2,213,742**

4 TREASURY MANAGEMENT OUTTURN 2008/09

4.1 The outturn position for treasury management activities was an underspend against budget of £728,692. The main reasons for this were:

a. Whilst investment interest rates were below the rates anticipated in the budget, the balances invested were generally higher due to delays in spending, and in particular slippage on the capital programme.

b. Borrowing costs were reduced due to delayed external borrowing and the application of a new capital regulation allowing the delay of Minimum Revenue Provision until the year following that in which an asset becomes operational.

5 THE STRATEGY FOR 2008/09

5.1 The Council currently has Sector Treasury Services Limited as its treasury advisers and part of their service is to assist in forming a view on economic trends and the effect on interest rates.

5.2 The Sector recommended treasury strategy for 2008/09 was based on their view of a declining rate of growth of GDP in the UK economy from the peak of 3.3% in Q3 2007 to 2% in 2008. House prices had started falling in 2007 and this was expected to continue throughout 2008. The combination of a high Bank Rate and hence mortgage rates, food prices rising at their fastest rate since 1993 and increases in petrol prices put consumer spending power under pressure.

5.3 It was envisaged that the Monetary Policy Committee (MPC) would be very concerned about inflationary pressures and so would be cautious about cutting interest rates.

5.4 In the 2008/09 strategy the effect on interest rates for the UK was therefore expected to be as follows:

Shorter-term interest rates - The Bank Rate had peaked in 2007/08 at 5.75% in July 2007 and had remained at this level until December 2007 when it was reduced to 5.50% and then to 5.25% in February 2008. Sector's interest rate forecast predicted 0.25% cuts would bring the Bank Rate down to 4.75% by the third quarter of 2008 and it would remain at this level until the end of the financial year.

Longer-term interest rates - The view on longer-term fixed interest rates, 50 years, was that they would remain static around 4.45% for the whole of the year. The 25 year rate would also remain fairly stable at around 4.50 - 4.55%. There was expected to be little difference between 5 – 50 year PWLB rates and little variation in rates during the year.

5.5 After taking into account the above the 2008/09 strategy was:

a. To undertake new borrowing over the longer term (50 year borrowing anticipated to be marginally cheaper than 25-30 year borrowing) and at any time in the financial year. A suitable "trigger" point for considering new fixed rate long term borrowing would be below 4.50%.

b. If shorter term rates become available around this rate they would also be considered. Variable rate borrowing was expected to be more expensive than long term borrowing and therefore unattractive throughout the year compared to long term borrowing.

c. Against the economic background, caution will be adopted with the 2008/2009 treasury operations. The Director of Resources would carefully monitor the interest rate market and adopt a pragmatic approach to any changing circumstances.

6 THE ECONOMY IN 2008/09

Shorter-term interest rates:

6.1 In a year that can only be described as unparalleled and extraordinary the financial crisis, commonly known as the 'credit crunch', had a major downward impact on the levels of interest rates around the world.

6.2 On 1st April 2008 Bank Rate was 5% and the Bank of England was focused on fighting inflation. Market fears were that rates were going to be raised because of concerns over inflationary pressures.

6.3 This phase continued throughout the summer until the 15th September when Lehman Brothers, a US investment bank, was allowed to file for bankruptcy in the absence of any other institution being willing to buy it due to the perceived levels of "toxic" debt it had. This event caused great concern in world financial markets and threatened to completely destabilise them. This also led to an immediate increase in investment rates as markets grappled with the implications this might have on other financial institutions, their credit standing and their viability. On 7th October the Icelandic government took control of their banks and this was followed a few days later by the UK government pumping a massive £37bn into three UK clearing banks, RBS/HBOS/Lloyds, as liquidity in the markets dried up in the UK. The Monetary Policy Committee had reduced interest rates from 5.00% to 4.50% on 8th October.

6.4 In 2008/09 market focus shifted from inflation concerns to concerns about recession, depression and deflation. Although inflationary concerns still persisted, they were seen as no barrier to interest rates being cut further. The MPC delivered another cut in interest rates in November, this time by an unprecedented 1.5%. Investors continued to place funds with Government securities. Yields in ten year PWLB temporarily below 4% and 5 years to around 3.5%. In December, the Bank of England cut interest rates to 2%. In early 2009 fifty year PWLB rates dropped below 4%.

6.5 On 8th January the MPC reduced rates by 0.5% to 1.5%, a record low. More Government support for the banking sector was announced on 19th January 2009. The debt markets had a sharp sell-off at this stage. This was because the amount of gilt issuance likely to be needed to finance the help provided to the banks. There was also discussion about further measures that could be introduced to encourage lending and economic activity. These included quantitative easing by the Bank of England; effectively printing money.

6.6 In February 2009 the MPC reduced the bank base rate to 1% followed by a further cut in March 2009 to 0.50%. The MPC also announced the quantitative easing scheme would start soon. This scheme would focus on buying up to £75bn of gilts in the 5-25 year maturity periods and £10 -15bn of corporate bonds. This led to a substantial improvement in the gilt market, particularly in the 5 to 10 year maturities, and PWLB rates fell accordingly.

6.7 The financial year ended with markets still badly disrupted, the economy suffering from a lack of credit, short to medium term interest rates at record lows and uncertainty as to how or when recovery would take place. Investment income returns have been badly hit but borrowing rates in short to medium periods have become lower.

6.8 **Longer-term interest rates:**

The PWLB 45-50 year rate started the year at 4.43% and was then generally within a band of 4.3 - 4.6% until mid October when they went up to 4.84% but then fell to 3.86% in early

December. Further spikes of 4.84% and 4.72% occurred in late January and early February with the year closing out at 4.58%. It was not uncommon to see rates fluctuating by 40-50 basis points within a few weeks during this year.

7. IMPACT UPON TREASURY MANAGEMENT ACTIVITIES

7.1 The main impact on the Council's investment activities was felt in the last four to six months of 2008/2009 through falling interest rates and a reduction in the Council's list of eligible counterparties.

7.2 With reference to the Council's borrowing, the council borrowed £10 million in September and October 2008 when interest rates fell below the target rate. Due to the difficulties in selecting eligible counterparties, coupled with the low interest being earned, the Council did not take out further borrowing but chose to reduce its investment balances.

8. COMPLIANCE WITH TREASURY LIMITS AND PRUDENTIAL INDICATORS

8.1 During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Policy Statement and annual Treasury Management Strategy. The outturn for the Prudential Indicators is shown in **Annex C**. The Prudential Indicators set out are recommended by the CIPFA Prudential Code for Capital Finance.