Agenda Item No. 8.3

WYRE FOREST DISTRICT COUNCIL

CABINET
22nd SEPTEMBER 2009

Annual Report on Treasury Management Service and Actual Prudential Indicators 2008/2009

OPEN	
COMMUNITY STRATEGY THEME	Internal Organisation Theme
CORPORATE PLAN THEME:	Improving Corporacy & Performance
CABINET MEMBER:	Councillor Nathan Desmond
DIRECTOR	Director of Resources David Buckland Ext. 2100 david.buckland@wyreforestdc.gov.uk
CONTACT OFFICER:	David Buckland Ext. 2100 david.buckland@wyreforestdc.gov.uk
APPENDICES	None

1. PURPOSE OF REPORT

1.1 The annual treasury report is a statutory requirement of the Council's reporting procedures. It covers the treasury activity for 2008/09 and the actual Prudential Indicators for 2008/09.

1.2 The report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

2. RECOMMENDATIONS

The Cabinet is asked to DECIDE:

1. **The actual 2008/09 Prudential Indicators detailed within the report be approved.**

2. **The Treasury Management Service Report for 2008/09 be approved.**

3. EXECUTIVE SUMMARY

3.1 During 2008/09 the Council complied with its legislative and regulatory requirements. The actual prudential indicators for the year, with comparators, are as follows:

Actual Prudential Indicators	**2007/08 £'000**	**2008/09 £'000**
Actual Capital Expenditure	3,959	4,391
Capital Financing Requirement	1,900	1,829
Financing Costs as a proportion of net revenue stream (this is a negative indicator as the Authority is in a net investment position)	(10.56%)	(3.48%)

3.2 The Director of Resources also confirms that prudential borrowing was only undertaken for a capital purpose and the Statutory borrowing limit, the Authorised Limit, was not breached.

3.3 At 31st March 2009, the Council's external debt was £37,620 (£40,862 at 31 March 2008) and its investments totalled £17.096m including an accounting adjustment of £3.316m in respect of Icelandic investments (the investments as at 31st March 2008 were £23.828m - no accounting adjustment in 2007/08).

3.4 The financial year 2008/09 presented exceptional circumstances with regard to treasury management. The downturn in the economy presented the Council with additional issues not normally encountered. In response to this the Council immediately restricted the counterparty list to those institutions with higher credit ratings. The main implications of the exceptional circumstances have been:

- Sums at risk with Icelandic institutions
- Deteriorating investment returns, resulting in reduced investment income from that originally budgeted
- Changes to the counterparty list and counterparty risk, resulting in reduced institutions that the Council could use

3.5 On 23rd October 2008 a report was presented to Cabinet formally revising the Treasury Management Policy. This, together with the increased counterparty credit risk in general, restricted the counterparty list further.

4. BACKGROUND

4.1 Introduction

This report summarises:

- the capital activity for the year
- how this activity was financed
- the impact on the Council's indebtedness for capital purposes
- the impact of this activity on the Council's underlying indebtedness (the CFR)
- the Council's overall treasury position
- the reporting of the required prudential indicators
- a summary of interest rate movements in the year

- debt activity
- investment activity

4.2 Council's Capital Expenditure and Financing 2008/09

4.2.1 The Council undertakes capital expenditure on long term assets. These activities may either be:

- Financed immediately through the application of capital receipts, capital grants, direct revenue financing etc.; or
- If insufficient financing is available the expenditure will give rise to a borrowing need.

4.2.2 Part of the Council's treasury activities is to address this borrowing need, either through borrowing from external bodies, or utilising temporary cash resources within the Council. The wider treasury activities also include managing the Council's cash flows, its previous borrowing activities and the investment of surplus funds. These activities are structured to manage risk foremost, and then optimise performance. Wider information on the regulatory requirements is shown in paragraph 4.10.

4.2.3 The actual capital expenditure forms one of the required prudential indicators. The table below also shows how this was financed.

	2007/08 Actual £'000	2008/09 Estimate £'000	2008/09 Actual £'000
Total capital expenditure	**3,959**	**7,639**	**4,391**
Resourced by:			
Capital receipts	1,914	5,298	2,893
Capital grants	1,278	1,666	1,131
Revenue	39	249	55
Unfinanced capital expenditure (additional need to borrow) Relates to Vehicle, Equipment & Systems Renewals Schedule	**728**	**426**	**312**

4.3 The Council's Overall Borrowing Need

4.3.1 The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This figure is a gauge for the Council's debt position. It represents 2008/09 and prior years' net capital expenditure that has not yet been paid for by revenue or other resources.

4.3.2 Part of the Council's treasury activities is to address this borrowing need, either through borrowing from external bodies, or utilising temporary cash resources within the Council.

4.3.3 The CFR is reduced each year by a statutory revenue charge (called the Minimum Revenue Provision - MRP). The total CFR can also be reduced by:

- the application of additional capital resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

4.3.4 With effect from 1 April 2008 the CLG introduced new MRP Guidance which requires an MRP Policy to be approved by Members. The policy for 2008/09 was approved by Council on 27th February 2008.

4.3.5 The Council's CFR for the year is shown below, and represents a key prudential indicator.

CFR	**31 March 2008 Actual £'000**	**31 March 2009 Original Indicator £'000**	**31 March 2009 Actual £'000**
Opening balance	1,485	1,900	1,900
Add: unfinanced capital expenditure	728	426	312
Less: MRP*	(313)	(399)	(383)
Closing balance **Relates to Vehicle, Equipment & Systems Renewals Schedule**	**1,900**	**1,927**	**1,829**

- A Minimum Revenue Provision is made to link the annual charge to revenue with the life of the asset.

4.3.6 The Balance Sheet CFR is reviewed annually by the Director of Resources, in liaison with Butlers (the Council's Treasury Consultants), and kept at a manageable level.

4.4 <u>Treasury Position at 31st March 2009</u>

4.4.1 Whilst the Council's gauge of its underlying need to borrow is the CFR, the Director of Resources can manage the Council's actual borrowing position by either borrowing to the CFR, choosing to utilise some temporary cash flow funds instead of borrowing (under-borrowing), or borrowing for future increases in the CFR (borrowing in advance of need).

4.4.2 It should be noted that the accounting practice required to be followed by the Council, the CIPFA Statement of Recommended Practice (the SORP), changed from the 2007/08 accounts, and required financial instruments in the accounts (debt, investments, etc.) to be measured in a method compliant with national Financial Reporting Standards. The figures in this report are based on the principal amounts borrowed and invested and so may differ form those in the final accounts by items such as accrued interest.

4.4.3 During 2008/09 the Director of Resources managed the debt by the use of temporary cashflow funds and did not utilise external borrowing. The treasury position as at 31st March 2009 compared with the previous year was:

Treasury position	31st March 2008		31st March 2009	
	Principal £'000	Average Rate	Principal £'000	Average Rate
Total Debt	**41**	**6.07%**	**38**	**6.11%**
Fixed Interest Investments	(23,828)	5.72%	(17,096)*	4.73%*
Variable Interest Investments(included in fixed)	-	-	-	-
Total Investments	**(23,828)**	**5.72%**	**(17,096)***	**4.73%***
Net investment position	**(23,787)**		**(17,058)**	

*Principal at 31st March 2009 includes Icelandic investments at impaired values. Average rate achieved excluding Icelandic investments

4.5 <u>Prudential Indicators and Compliance Issues</u>

4.5.1 Some of the required prudential indicators provide either an overview or specific limits on treasury activity. These are shown below:

4.5.2 **Net Borrowing Levels and the CFR** - In order to ensure that borrowing levels are prudent, over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. Net borrowing should not therefore, except in the short term, exceed the CFR for 2008/09 plus the expected changes to the CFR over 2009/10 and 2010/11. Since the Council's investments considerably exceed the minimal amount borrowed, the net position is well below the CFR. The table below highlights that the Council has complied with this requirement.

	31 March 2008 Actual £'000	31 March 2009 Original Indicator £'000	31 March 2009 Actual £'000
Net investment position	**(23,787)**	**(19,961)**	**(17,058)**
CFR	**1,900**	**1,927**	**1,829**

4.5.3 **The Authorised Limit** - The Authorised Limit is the "Affordable Borrowing Limit" required by Section 3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2008/09 the Council has maintained gross borrowing within its Authorised Limit.

4.5.4 **The Operational Boundary** – The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or over the Boundary is acceptable subject to the Authorised Limit not being breached.

4.5.5 **Actual financing costs as a proportion of net revenue stream** - This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2008/09
Original Indicator - Authorised Limit	**£3.50m**
Maximum gross borrowing position during 2008/09	**£299,791**
Original Indicator - Operational Boundary	**£0.50m**
Average gross borrowing position during 2007/08	**£15,310**
Minimum gross borrowing position	**0**
Actual Financing Costs as a proportion of net revenue stream	**(3.48%)**

4.6 Economic Background for 2008/09

4.6.1 The 2008/09 financial year has featured one of the most testing and difficult economic and investment environments since the 1930's. It has featured a number of very significant changes in the performance of the UK as well as global economy. Beneath all of this has been the undercurrent of uncertainty and mistrust in the financial markets. This was not an easy backdrop in which to manage an investment portfolio.

4.6.2 The year opened on an uncertain note. The ongoing effects of the "credit crunch" that had started in 2007 prompted a bout of monetary policy easing in early April 2008 when the Bank of England cut its Bank Rate by 0.25% to 5%.

4.6.3 But inflation was rising sharply, due to the strength of global commodity and food prices and the very steep rise in oil prices. The Consumer Price Index (CPI) inflation measure breached the 3% upper limit of the Governments' target range in April 2008. The Bank was concerned that these external cost pressures could eventually transform into a domestic wage/price spiral and kick start a bout of damaging inflation.

4.6.4 Rates were left on hold through the summer months and there seemed to be some signs of a gradual return to slightly more normal conditions in the money markets. But this was not to last. Mid-September saw a "sea change" in financial markets and economic policies. The collapse of US investment bank, Lehman Brothers, dealt a devastating blow to the markets. Liquidity dried up almost completely making it extremely difficult for banks to function normally. These developments culminated in the failure of the entire Icelandic banking system in early October 2008.

4.6.5 The failure of the Icelandic banking system had a major impact on local authority investments. A number of local authorities had deposits with Icelandic institutions and these investments are still at risk. At this point in time recovery rates have not been fully disclosed by the respective institutions, although early indicators suggest a good, albeit not 100% recovery.

4.6.6 At 31st March 2009 the Council had £9m of investments with Icelandic institutions. All accrued interest up until bank failure date has been accounted for in accordance with CIPFA Local Authority Accounting Panel (LAAP) Bulletin 82. The investments have been impaired in line with proper accounting practice and the CLG Regulations. Further accounting adjustments will be made in subsequent financial years.

4.6.7 In July 2009 the Council received two interim distributions in respect of the Icelandic investments totalling £1,197,553.

4.6.8 The crisis in the financial markets deepened and threatened a complete 'melt-down' of the world financial system. This, together with evidence that economies had entered recession prompted a number of significant policy changes. In the UK these featured the following:

- a major rescue package totalling as much as £400bn to recapitalise the banking system
- a series of interest rate cuts down to 2% in early December
- a fiscal expansion package, including a 2.5% cut in VAT.

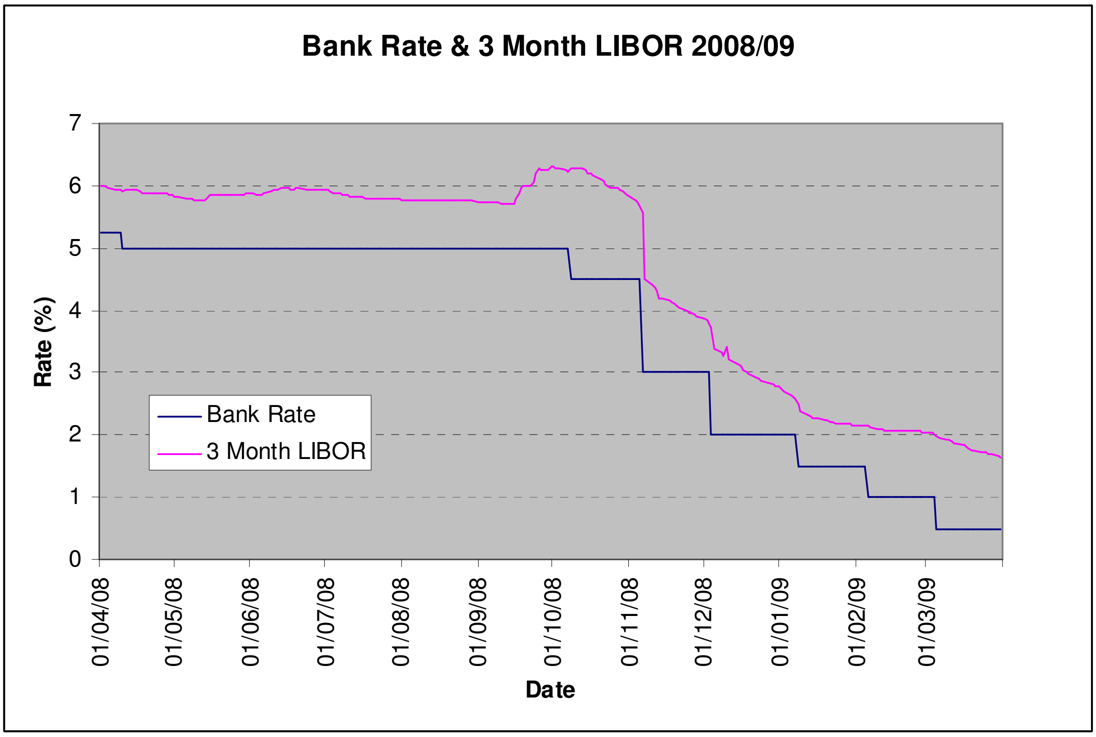
4.6.9 The New Year failed to herald a change in the fortunes of the banking sector. Central banks continued to ease monetary policies in an attempt to reduce borrowing rates and hence alleviate some of the cost pressures being experienced by financial institutions and the corporate and household sectors.

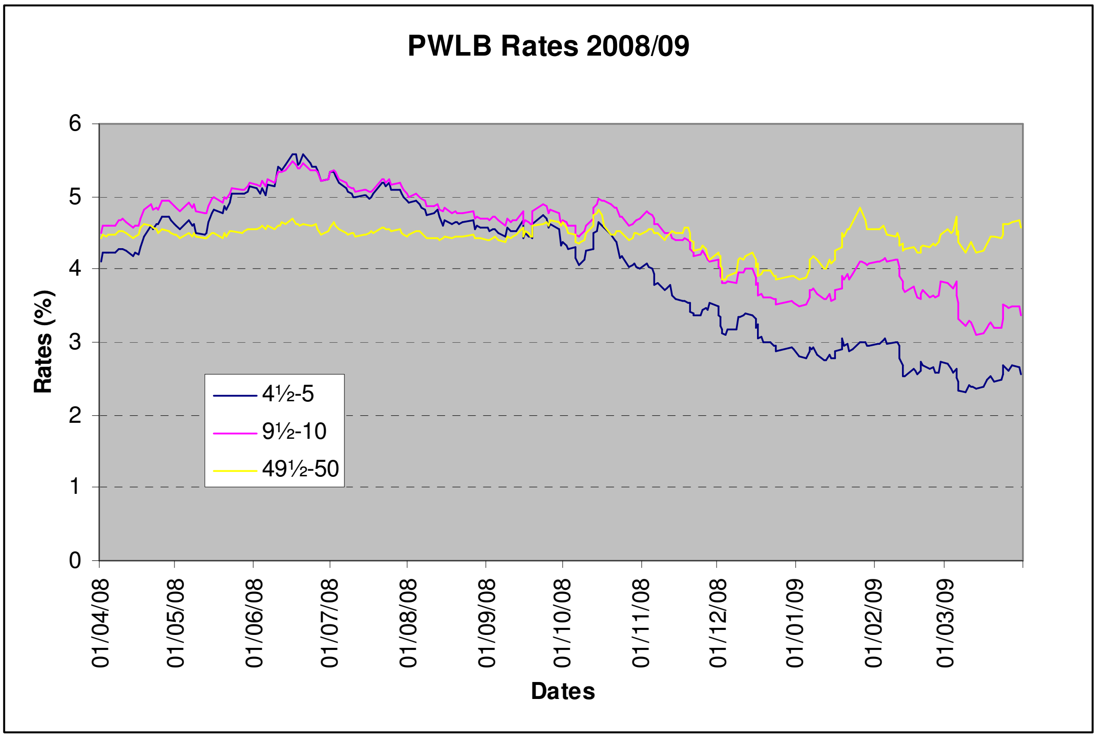
4.6.10 With official interest rates in the US already at close to zero at end of 2008, the Bank of England was at the forefront of policy easing. Bank Rate was cut in successive monthly moves from 2% at the outset of the year to the historically low level of 0.5% in March. Thereafter, the Bank resorted to the quantitative easing of monetary policy via a mechanism of buying securities from investment institutions in exchange for cash. This commenced in early March and is expected ultimately to amount to reach £150bn.

4.6.11 Aside from Bank of England assistance, the central government launched the second phase of its support operations for the banking industry during the second half of January. This failed to allay fears that even more aid might have to be extended to the banking industry before the crisis is over. During the course of the quarter, two major banks, RBS and Lloyds Group, needed substantial cash injections; action that led the public sector to assume near-full ownership. In addition to this, the Dunfermline Building Society was rescued from bankruptcy.

4.6.12 The problems of the financial markets since late 2007 had clearly spread to other parts of the economy. Economic data confirmed that the UK was in deep recession and the latest Bank of England Inflation Report (published in mid-February) registered a marked change in official forecasts for 2009 and 2010. Economic activity was expected to decline sharply (GDP was forecast to contract by more than 4% in 2009) and inflation was projected to fall into negative territory.

4.6.13 The generally uncertain backdrop to the UK and the financial markets prevented a marked easing in overall money market liquidity. While the situation did show some signs of improving as the financial year drew to a close, the margin between official interest rates and those quoted in the inter-bank market for periods longer that 1-month remained very wide.





4.7 The Strategy Agreed for 2008/09

4.7.1 The strategy provided for 2008/09 was approved by Council on 27th February, 2008 – Council Minute C.82 (13.2). In response to the unprecedented downturn in the economy, Cabinet on 23rd October 2008 recommended to Council to revise the Treasury Management Policy. This was approved by Council on 26th November 2008 – Council Minute C.57.

4.7.2 Full details of the approved strategy can be found in the Report to Cabinet on 21st February 2008, along with revisions to the strategy on 23rd October 2008. In summary the planned treasury activity was as follows:

Borrowing

1. To fund the Capital Programme requirements from the Council's own capital receipts and grants.

2. The Vehicle, Equipment and Systems Renewals to be funded by means of medium term borrowing and direct revenue financing.

3. To fund any projected overdrawn balances by appropriate borrowing.

Investments

1. To lend funds which are surplus (after cash flow requirements have been taken into account) on a longer term basis where short term interest rates are projected to fall or show little upwards movement. This was revised in October 2008 to allow short term investments only in accordance with the revised counterparty list.

2. Should investment requirements exceed £10million and market conditions are likely to be favourable, to appoint suitable Investment Managers at the appropriate time in accordance with the Council's Standing Orders Relating to Contracts.

3. Alternatively, should short term interest rates be forecast to move noticeably upwards, to lend surplus funds on a shorter term basis, unless materially higher long term interest rates can be obtained, when surplus funds should be lent on a longer term basis. Again, this has been revised since a cautious approach to investments was introduced in the October 2008 Cabinet report.

4.8 Investment Position

4.8.1 **Investment Policy –** The Council's investment policy is governed by guidance issued by the former Office of the Deputy Prime Minister (ODPM) that has been implemented in the annual investment strategy approved by Council on 27th February 2008 with an update approved by Council on 26th November 2008. The investment activity during the year conformed to the approved strategy, and the only liquidity difficulties were the £9m that had been 'frozen' due to the collapse of the Icelandic banking system.

4.8.2 **Resources –** The Council's longer term cash balances comprise primarily revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources, excluding other day to day cashflow balances, comprised:

Balance Sheet Resources	31 March 2008 £'000	31 March 2009 £'000
General Fund Revenue Balance	4,197	2,843
Earmarked reserves	1,756	1,730
Provisions	40	238
Usable capital receipts	18,198	15,328
Total	**24,191**	**20,139**

4.8.3 **Investments Held by Fund Managers** The Council did not use Fund Managers during 2008/09.

4.8.4 **Investments Held by The Council** - The Council does not have the expertise or resources to actively use a wide range of investment products and therefore performance tends to be more stable but lower over the longer term than for professionally managed funds (whose performance may fluctuate more). The Council maintained an average balance of £20.685m excluding the £9m Icelandic investments and received an average return of 4.73%. The comparable performance indicator is the average 7 day London Interbank Bid (LIBID) rate, which was 3.61%. This compares with a budget assumption of approximately £31m investment balances at 4.5% interest rate. The favourable return was due to a fixed term investment that had been placed in April 2006 at 5.3%, maturing in April 2009. External Interest received totalled £979,299 compared to the revised budget of £1,389,360.

4.8.5 The Economic Background for 2008/09 (see Section 4) sets out the deterioration in economic conditions during this period. As a result of the deterioration, interest rates fell impacting adversely on investment returns. As a result of the economic situation, the security of banks was called into question, shown by falling credit ratings for the majority of financial institutions.

4.8.6 The Council holds investments on behalf of a number of related bodies including Parish Councils and Kidderminster Educational Foundation.

4.9 <u>Performance Indicator set for 2008/09</u>

This service has set the following performance indicator :-

- Investments – Internal returns (4.73%) above the 7 day London Interbank Bid (LIBID) rate (3.61%)

4.10 <u>Regulatory Framework, Risk and Performance</u>

4.10.1 The Council's treasury management activities are regulated by a variety of professional codes, statutes and guidance:

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;
- The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken (although no restrictions were made in 2007/08);

- Statutory Instrument (SI) 3146 2003, as amended, developed the controls and powers within the Act;
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA) Prudential Code for Capital Finance in Local Authorities;
- The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;
- Under the Act the former ODPM (now CLG) has issued Investment Guidance to structure and regulate the Council's investment activities.
- Under section 238(2) of the Local Government and Public Involvement in Health Act 2007 the Secretary of State has taken powers to issue guidance on accounting practices. Guidance on Minimum Revenue Provision was issued under this section on 8th November 2007.

4.10.2 The Council has complied with all of the above relevant statutory and regulatory requirements which limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

4.10.3 The Council has fully co-operated with a number of internal and external reviews into the Icelandic investments, including a member Treasury Management Review Panel, that showed full compliance with all approved policies and procedures.

4.10.4 The Council is aware of the risks of passive management of the treasury portfolio and, with the support of Butlers, the Council's advisers, has proactively managed its treasury position.

4.10.5 Shorter-term rates and likely future movements in these rates predominantly determine the Council's investment return. These returns can therefore be volatile and, whilst the risk of loss of principal is minimised through the annual investment strategy, accurately forecasting future returns can be difficult.

5. KEY ISSUES

5.1 Key Issues are contained within paragraph 4 – background.

6. FINANCIAL IMPLICATIONS

6.1 The Financial Implications are contained within paragraphs 4.2, 4.3.1, 4.4.1 and 4.8.4.

7. LEGAL AND POLICY IMPLICATIONS

7.1 Legal and Policy Implications are contained within paragraph 4.10.1.

8. RISK MANAGEMENT

8.1 Risk Management is contained within paragraphs 4.10.2, 4.10.3 and 4.10.4. As demonstrated within this report the current economic position is very erratic; as a result, the risk is managed by more frequent and detailed reviews supported by the Treasury Management Panel. The Council will continue to invest with only those institutions which have the necessary credit ratings in order to preserve the Council's Capital.

9. CONCLUSION

9.1 The Cabinet is asked to approve the recommendations, contained within paragraph 2.

10. CONSULTEES

10.1 Corporate Management Team
Butlers, Treasury Management Consultants

11. BACKGROUND PAPERS

11.1 Treasury Management Strategy 2008/09 approved by Council on 27th February 2008 - Council Minute C.82 (13.2)

11.2 Revision to the Treasury Management Strategy 2008/09 approved by Council on 26th November 2008 - Council Minute C.57