St Edmundsbury
BOROUGH COUNCIL

A145

Cabinet
29 July 2009

Treasury Management: Annual Report 2008/2009 and Investment Activity 1 April to 30 June 2009

1. Summary and Reasons for Recommendations

1.1 The Council's treasury management activities generate a substantial amount of income and therefore warrant regular Member consideration. The purpose of this report is to:-

(a) present the annual treasury management investment report summarising the investment activities for the year 2008/2009;

(b) provide a summary of investment activity for the first three months of the 2009/2010 financial year; and

(c) advise members of on-going measures being taken by the Chief Finance Officer to mitigate the risks associated with the current banking crises.

1.2 Despite the credit crunch and international banking crises, the Council's treasury management activities have continued to exceed budgeted rates of return on investments. Furthermore, the Council was not affected by the collapse of the Icelandic banks and has not, to date, suffered any loss arising from the failure of a financial institution.

1.3 The budgeted income from investments in 2008/2009 was £2.102m, equivalent to £55.92 for each Council Tax band D property. As at 31 March 2009, interest earned amounted to £3.085m; a surplus for the year of £0.983m. This represents an average rate of return on investments for the year of 5.14% compared to a budgeted rate of return of 4.75%. The reasons for the surplus over budget include achieving a higher average rate of interest than anticipated and slippage in the capital programme.

1.4 Looking ahead to 2009/2010, the Council is obviously not immune from the impact of the recent collapse in interest rates and investment returns. The 2009/2010 budgets are based on a target rate of return during the year of 2.20% producing an estimated level of investment income of £0.751m. Investment income for the first quarter of the 2009/2010 financial year (1 April to 30 June) totalled £0.339m against a profiled budget for the period of £0.220m, representing a budget surplus of £0.119m.

1.5 The Council's Annual Treasury Management and Investment Strategy 2009/2010, approved by Council on 24 February 2009, sets out minimum credit worthiness criteria for the use of formally rated banks and non-rated building societies. These criteria had been reviewed to take on board the unprecedented nature of the current banking crisis. Since this time further enhancements have been made, particularly in respect of non-rated building societies, with a view to providing further investment security and increasing the spread of investments. Details of action taken to date are included within this report.

2. Recommendations

2.1 The information on the operation of the treasury management function for the year 2008/2009, as set out in the Annual Treasury Report at Appendix 1 to this report, be noted.

2.2 Information on the treasury management function for the period 1 April to 30 June 2009, as detailed in the report, be noted.

2.3 Information on enhancements made to criteria for assessing the creditworthiness of financial institutions, as detailed in this report, be noted.

3. Corporate Objectives

3.1 The recommendations meet the following, as contained within the Corporate Plan:-

(a) Corporate Priority : '*To raise corporate standards and efficiency*'; and
(b) Cabinet Commitment : '*Improving Efficiency and Value for Money*'.

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4. Key Issues

4.1 The Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management, adopted by the Council in March 2002, requires that the Cabinet receives periodic progress reports on treasury management activities during the course of the year culminating in an annual report at the end of the financial year.

Annual report 2008/2009

4.2 The Council's treasury management annual report for 2008/2009 is attached at Appendix 1.

4.3 Despite the credit crunch and international banking crisis, the Council's treasury management activities during 2008/2009 continued to exceed budgeted rates of return on investments. The Annual Treasury Management and Investment Strategy for 2008/2009, approved by Council on 26 February 2008, set out the Council's projections for the financial year, which were based upon interest rate forecasts provided by a range of market analysts and the advice of the Council's treasury management advisors, Sector. The budgeted income from investments in 2008/2009 was £2.102m, equivalent to £55.92 for each Council Tax band D property. As at 31 March 2009, interest earned amounted to £3.085m, producing a surplus for the year of £0.983m. Of this, £0.671m has been credited to the General Fund, to be used to support council tax levels, with the remainder being credited to earmarked reserves to reflect the gains attributable to the investment of these balances.

4.4 The reasons for the surplus over budget were due primarily to achieving a higher average rate of interest than anticipated together with slippage in the capital programme. The average rate of return on investments for the year was 5.14% compared to a target rate for the year of 4.75%. The actual level of capital expenditure during the year was £22.570m compared to an original budget of £29.468m.

4.5 Given the significant sums that are invested and the amount of interest earned, fluctuations in interest rates and in levels of planned capital expenditure and receipts have a major impact on the budget. The establishment of the Interest Equalisation Reserve, as agreed by Council in February 2005, assists in smoothing out the year-on-year impact of variations in planned investment returns.

Investment Activity: 1 April to 30 June 2009

4.6 The total amount invested at 1 April 2009 was £46.550m and at 30 June 2009 £45.450m.

4.7 The budget for investment income in 2009/2010 is £0.751m, equivalent to £19.87 for each Council Tax Band D property. At the end of June 2009 interest earned amounted to £0.339m against the profiled budget for the period of £0.220m, a surplus of £0.119m. The over achievement of interest on investments during this period was due to higher than expected interest rates and to slippage on the capital programme. The target investment rate for the year is 2.20%. In the three month period covered by this report, the average rate of interest achieved has been 2.88%. Furthermore, as at 30 June 2009 only £1.766m had been spent out of the full year's original capital programme budget of £25.388m.

4.8 The target investment rate of 2.20% was set in February 2009 as part of the budget setting process and was based on interest projections provided by the Council's external treasury advisors, Sector, together with an assessment of the returns achievable on fixed term investments with different maturity dates. The financial year commenced with an

interest base rate of just 0.5%, an historic low, and remained at this level for the remainder of the period.

4.9 Due to continuing concerns about the current economic recession, Sector are currently predicting that the Bank of England's Monetary Policy Committee will hold rates at this historic low for some time. As a result, investments are currently being made at rates below the average target rate for the year (which takes into account the higher rates of returns being gained on some of the Council's fixed term investments). As more of the fixed term investments reach maturity, the average return on the Council's portfolio of investments is likely to reduce. However, provided there is not a further reduction in the value of investment returns, and conditional upon the achievement of the current capital expenditure and capital disposals programme, then the budgeted income from investments for 2009/2010 should still be achievable.

Credit Rating Criteria

4.10 The unprecedented nature of the current banking crisis has forced all local authorities to review their approach to assessing the credit worthiness of banks and financial institutions. The Council's minimum criteria for assessing the credit worthiness of investment counterparties (i.e. organisations with which the Council places investments) are set out in the Annual Treasury Management and Investment Strategy 2009/2010. In assessing the credit risk associated with individual financial institutions the Council uses the credit worthiness service provided by Sector, which in turn is based upon the assessments provided by Fitch and Moody credit rating organisations. Meanwhile investments in non-rated building societies are restricted to building societies with asset bases in excess of £1,000m (equating approximately to the top 20 building societies in the UK). The 2009/2010 Strategy included a number of enhancements designed to respond to the credit crisis, including criteria to cover the newly nationalised banks and the use of sovereign ratings.

4.11 Since this time, and in response to continuing difficulties within the banking sector, Sector have recommended a further tightening of the Council's credit worthiness criteria, including significant reductions in the maximum duration and value of investments that can be held with individual institutions. Therefore the maximum maturity periods for Council investments has been substantially reduced from 5 years to 1 year, and the maximum value of investments with individual rated organisations meeting the required credit criteria have been halved from £10m to £5m. These measures have been taken to try to limit the exposure in any one organisation and spread risk.

4.12 The Council's current Treasury Management Strategy provides for the use of non rated building societies with assets over £1,000m. Whilst this approach has been broadly accepted by Sector in the past, they have re-emphasized their previous advice that non-rated institutions, including non rated building societies, are potentially higher risk due to lack of externally assessed ratings upon which to make informed judgements about their credit worthiness. As such they recommend that in assessing the credit worthiness of non rated building societies reliance should not be placed simply on asset base sizes and league tables.

4.13 In response to such warnings, many local authorities have discontinued the use of non rated building societies in preference for high rated banks and government investments, via deposits with the Debt Management Office (DMO). These higher quality investments provide a greater degree of security, but are often at substantially lower rates of interest (DMO rates are typically at or below bank base rate levels). The dilemma faced by local authorities in balancing security risks with the need to maintain reasonable investment returns (and council tax levels) was acknowledged in a recent Community and Local Government Select Committee report into local authority

investments (published June 2009).

"Investing in Government stock only, though certainly ensuring security, would severely limit local authorities' investment options, hamper the role they play in financial markets, and be unlikely to provide the required liquidity and return. The more realistic approach is the one which obtains at present: to allow riskier investments which provide good levels of liquidity and return, but to have in place a responsive, flexible network of advice, guidance and scrutiny which ensures a proper spread of risk."

4.14 As a result officers have been working in consultation with Sector to develop additional measures to limit the potential risks associated with the use of non-rated building societies. Measures already introduced include:-

(a) the maximum cumulative value of investments placed with any one building society has been reduced from £5m to £2.5m, with maximum investment durations reduced from 3 years to 6 months;

(b) only building societies specifically covered by the provisions of the Government's banking support package will be used;

(c) a commercial credit rating organisation, Dun and Bradstreet, is now being used to provide credit rating reports on building societies, prior to the placing of funds, to ensure that the proposed investment values are within recommended credit limits;

(d) latest available accounts are obtained and reviewed by in house staff to establish key trends and to ensure that Dun and Bradstreet recommendations are based on latest available financial results; and

(e) review of available media coverage for any advance negative warnings regarding the stability of individual building societies.

4.15 The adequacy of the above measures are to be subject to on-going review. In response to increasing demands from local government clients for greater market intelligence (ie beyond the formal credit ratings), Sector are looking into alternative measures of assessing the credit worthiness of building societies, including use of the FSA's stress testing data. The Chief Finance Officer, in consultation with the Portfolio Holder for Resources and Efficiency, will continue to monitor the adequacy of the above arrangements and make changes as necessary to respond to the changing economic climate and external advice, including advice and guidance from central government, Sector, the Chartered Institute of Public Finance and Accountancy and the Audit Commission). Details of any further changes in the treasury management function, including changes to the credit worthiness criteria will be reported to Cabinet as part of the quarterly treasury management report.

5. Other Options considered

5.1 The Code of Practice requires that the Cabinet receives periodic progress reports on treasury management activities during the course of the year and an annual review report after the end of the financial year.

6. Community impact *(including Section 17 of the Crime and Disorder Act 1998 and diversity issues)*

6.1 General

6.1.1 The level of interest earned on investments is used to help fund the costs of Council services and reduces the demand on the Council Tax payer.

6.2 Diversity

6.2.1 All Council Taxpayers in St Edmundsbury benefit from the income achieved on the investment of Council balances and reserves.

7. Consultation

7.1 The Council's treasury management advisers, Sector, provide guidance on all aspects of the treasury management function, including the development of investment policies and strategies, investment products, the training of staff and the credit worthiness of investment counterparties.

8. Resource implications *(including asset management implications)*

8.1 Investment income of £3.085m was achieved during 2008/2009 representing income per Council Tax band D equivalent property of £82.07. The comparative budget figures for the year were £2.102m and £55.92. Budgeted investment income for 2009/2010 is £0.751m, equivalent to £19.87 for each Council Tax band D property. Interest earned in the first quarter of 2009/2010 totals £0.339m against a profiled budget for the period of £0.220m.

9. Risk Assessment *(including Health & Safety, potential hazards or opportunities affecting corporate, service or project objectives)*

9.1 Active measures are taken to minimise the Council's exposure to the unpredictability of financial markets and to protect the financial resources available to fund services. Investment activities are carried out in accordance with the approved Annual Strategy and comply with the CIPFA Code of Practice. The treasury management function is supported by external advisors, Sector, who provide on-going advice on investment strategies and policies together with daily updates on the credit rating of individual banks and building societies.

9.2 The interest obtained on the investment of the Council's balances is significant and helps to support the annual level of Council Tax. As fluctuations in interest rates and levels of capital expenditure and receipts can impact considerably on the Council's budget, an Interest Equalisation Reserve has been established to help smooth out year-on-year variances in investment returns.

Risk area	**Inherent level of Risk** (before controls)	**Controls**	**Residual Risk** (after controls)
Economic (fluctuations in interest rates)	High	Spread of investments for periods of up to two years (one year for new investments).	High
Bank / building society failure resulting in loss of Council funds.	High	Use of Sector advice on credit ratings (based on Fitch and Moody ratings), restrictions on the value and amount of investments with individual organisations, additional financial checks on non-rated building societies and the use of sovereign ratings to	High

		assess ability of countries to support failing banks.	
Fluctuations in capital expenditure and asset disposal programmes having significant impact on target investment returns	Medium	Budget monitoring Interest Equalisation Reserve	Medium

10. Legal or policy implications

10.1 Consideration of the report complies with Council policy and the CIPFA Code of Practice on Treasury Management.

Wards affected	All	**Portfolio Holder**	Resources and Efficiency
Background Papers		**Subject Area** Finance	

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Annual Treasury Report 2008/2009

1 Introduction

1.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management 2001 was adopted by the Council on 21st March 2002. One of the requirements of the Code is the receipt by the Cabinet of an annual strategy report for the year ahead and an annual review report of the previous year.

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.'

2 Background

2.1 The Council became debt free in 1992 and since then has refrained from any borrowing apart from the temporary use of overdraft facilities. This was continued in 2008/09 with the result that the Council had no Prudential Code indicators so far as borrowing was concerned in the year. During the financial year all the Council's investments were managed by in-house staff.

3 Investment Strategy for 2008/09

3.1 The investment objective for 2008/09 was for investments to be made prudently with priority being given to security and liquidity as well as yield.

3.2 The target rate of return for investments for 2008/09, was 4.75%. Based upon the anticipated funds available for investment in the year this gave a target investment income of £2.102m, equivalent to £55.92m for each Council Tax band D property. This figure was used in the preparation of the Council's budget for 2008/09.

3.3 The Treasury Strategy including the target interest rate for investments was based upon advice received from the Council's Treasury Management advisors, Sector Treasury Services Ltd (Sector). At the time when the strategy was set, the prediction was for the base rate to fall from 5.25% in the first quarter, to 5% in second quarter and stabilising at 4.75% from the third and fourth quarters. In view of this outlook for interest rates, investments were to be made with reference to cash flow requirements during the year (including the need to fund the Council's substantial capital programme expenditure plans) and also to take advantage of opportunities to invest for longer periods in order to provide certainty of investment income from a proportion of the Council's investments and maintain overall returns at the target level.

4 The Economy and Interest Rates in 2008/09

4.1 Sector has provided the following commentary on the performance of the economy and interest rate in 2008/2009.

Financial commentary 2008/09 *- The financial crisis, commonly known as the 'credit crunch', had a major downward impact on the levels of interest rates around the world. Although interest rates initially fell sharply in the US they were followed, eventually, by the Bank of England. 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 as CPI, the Government's preferred inflation target, was well above the 2% target (two years*

ahead). The money market yield curve reflected these concerns with one year deposits trading well above the 6% level. Public Works Loan Board (PWLB) rates in both 5 and 10 years edged above Bank Rate during the summer as markets maintained the belief that inflation was the major concern of the monetary authorities. The money markets were reflecting some concerns about liquidity at this time and the spread between Bank Rate and 3 month LIBOR was greater than had historically been the case.

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 total absence of any other institution being willing to buy it due to the perceived levels of toxic debt it had. This event caused a huge shock wave in world financial markets and threatened to completely destabilise them. This also led to an immediate spike up in investment rates as markets grappled with the implications this might have on other financial institutions, their credit standing and indeed 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. The Monetary Policy Committee meantime had reduced interest rates by 50bp on 9th October. This had little impact on 3 month LIBOR, however, as the spread, or 'disconnect' as it became known, against Bank Rate widened out. On the other hand the short end of the PWLB fell dramatically as investors, very concerned about their counterparty limits post the Icelandic banks' collapse, fled to the quality of Government debt forcing yields lower.

Market focus now shifted from inflation concerns to concerns about recession, depression and deflation. Although CPI was still well above target it was seen as no barrier to interest rates being cut further. The MPC duly delivered another cut in interest rates in November, this time by an unprecedented 1.5%. Investors continued to pour money into Government securities across the curve, at the front end because of credit concerns and the longer end because of the economic consequences reducing inflation, driving yields in 10 year PWLB temporarily below 4% and 5 years to around 3.5%. In December as the ramifications of the 'credit crunch' became increasingly clear the Bank of England cut interest rates to 2% - a drop this time of 1%. The whole interbank yield curve shifted downwards but the 'disconnect' at the short end remained very wide, negating to some degree the impact of the cuts in Bank Rate. 50 year PWLB rates dropped below 4% at the turn of the year, marking the low point, as it turned out, in this maturity.

The New Year of 2009 brought little relief to the prevailing sense of crisis and 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 as they took fright at 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 kick start lending and economic activity. These included quantitative easing by the Bank of England, effectively printing money.

In February 2009 the MPC adopted the traditional method of monetary easing by cutting interest rates again by 0.5% to 1%. Interbank rates drifted down with the spread in the 3 months still well above Bank Rate. In early March Lloyds Banking Group, which now included HBOS, took part in the Government's Asset Protection scheme. The MPC cut interest rates yet again to 0.5% and 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 rally in the gilt market, particularly in the 5 and 10 year parts of the curve, and PWLB rates fell accordingly. Finally at the end of March it was announced that the Dunfermline Building Society had run into difficulties and its depositors and good mortgages were taken over by Nationwide whilst the Treasury took on its doubtful loans.

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

5 Compliance with Treasury Limits

5.1 During the financial year the Council operated within the Treasury limits and Prudential Indicators set out in the Council's Treasury Policy Statement and annual Treasury Strategy Statement. In addition no institutions in which investments were made had any difficulty in repaying investments and interest in full during the year.

6 Investment Outturn 2008/2009

6.1 Investments were made with counterparties that met the agreed lending criteria and investment periods range from overnight to two years (one year for new investments), dependent on the Council's cash flows, the view on interest rates and the actual interest rates on offer.

Activity in 2008/09

6.2 Market investments in the year are summarised as follows:

	Number	Value (£m)
Opening balance 1st April 2008	31	56.20
Add: Investments made during the year	107*	118.45
Sub Total		174.65
Investments realised during the year	107**	128.10
Balance at 31st March 2008	32	46.55

* *Includes 20 investments into Business Reserve Accounts*
** *Includes 21 withdrawals from Business Reserve Accounts*

6.3 Investments were made in a number of longer dated deposits, callable deposits and forward investments. These arrangements were made in order to lock into interest rates which exceed the Council's budgeted rate and to provide some certainty of return for a proportion of the Council's investments. In this respect as at 31st March 2009 the Council held callable deposits totalling £10m, the longest of which could run to March 2011, with interest rates varying from 3.40% to 4.85%.

6.4 During the year, for cash flow generated balances, greater use was made of the instant access and 7 day notice business reserve accounts with Abbey National Plc and the Bank of Scotland. At 31st March 2009, in order to maintain liquidity whilst at the same time achieving earnings in excess of base rate, £6.55m was held in these accounts at interest rates of between 0.51% to 0.65%.

6.5 At the financial year end the balance of the portfolio, £30m, was held in 28 separate investments maturing before February 2010 in rates varying from 6.45% to 0.80%.

Balance Invested

6.6 The average daily investment for the year was £59.55m and ranged from a high of £67m in June 2008 to a low of £46.55m in March 2009.

Interest Earned

6.7

	Interest Rate	Interest Earned
	%	£
2008/03 Budget	4.75	2.102m
2008/09 Outturn	5.14	3.085m

6.8 The total interest earned in 2008/09 from the Council's investments amounted to £3.085m against a budget of £2.102m, i.e. an excess of £0.983m. Overall this is a return in the period of 5.14% compared to the original target of 4.75%. This level of interest represents an income per Council Tax band D equivalent property of £82.08 in 2008/09 compared to a budgeted income of £55.92.