Appendix 1

ANNUAL REPORT ON TREASURY MANAGEMENT & ACTUAL PRUDENTIAL INDICATORS

2008/09

INTRODUCTION

1. The annual treasury report is a requirement of the Council's reporting procedures. It covers the treasury activity during 2008/09, and the actual Prudential Indicators for 2008/09. The report meets the requirements of both the 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. The financial year 2008/09 presented exceptional circumstances with regard to treasury management. The downturn in the economy, coupled with increased counterparty risk presented the Council with additional issues not normally encountered. The main implications of the exceptional circumstances have been:-

   - A number of Councils have investments at risk in Icelandic institutions
   - Deteriorating investment returns, which will result in reduced investment income for at least the next two years
   - Increase in counterparty risk. The Council changed its Treasury Management Strategy during the year in response to the banking crisis to increase the maximum amount that can be placed with top rated banks and building societies; to allow longer term investments where the opportunity arises; and to allow investment with Government supported banks and building societies where the ratings would not normally allow this.

3. This report summarises:-
   - The capital activity for the year and the impact on the Council's debt position;
   - The reporting of the required prudential indicators;
   - The overall treasury position
   - A summary of interest rate movements in the year;
   - The detailed debt activity; and
   - The detailed investment activity

THE COUNCIL'S CAPITAL EXPENDITURE AND FINANCING 2008/09

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

	2007/08	2008/09	
	Actual £000's	**Estimate £000's**	**Actual £000's**
Total capital expenditure	60,290	66,313	56,824
Resourced by:			
Capital Receipts	8,978	14,043	11,952
Capital grants	30,375	32,595	25,961
Capital reserves	5,903	5,870	6,553
Revenue	4,873	1,255	4,529
Unfinanced capital expenditure (additional need to borrow)	10,161	12,550	7,829

THE COUNCIL'S OVERALL BORROWING NEED

5. 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 and represents 2008/09 and prior years net capital expenditure that has not been charged to revenue. The Non-Housing Revenue Account element of 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.

6. With effect from 1st April 2008 the Department for Communities and Local Government introduced new MRP guidance which requires an MRP Policy to be approved by members. The policy for 2008/09 was included in the Treasury Management Strategy contained within the Review of the Medium Term Financial Plan and Budget 2008/2009 Report agreed by Council on 27th February 2008. The Council's CFR for the year is shown below, and represents a key prudential indicator.

Capital Financing Requirement	**31st March 2008**	**31st March 2009**	
	Actual £000's	**Original Indicator £000's**	**Actual £000's**
Opening balance 1st April	259,876	251,361	250,463
Plus unfinanced capital expenditure	-3,959	12,550	7,829
Less MRP	5,454	-4,689	4,653
Closing balance 31st March	250,463	259,222	253,639

TREASURY POSITION at 31st MARCH 2009

7. Whilst the Council's gauge of its underlying need to borrow is the Capital Financing Requirement, the Corporate Director of Resources can manage the Council's actual borrowing position by either:-
   - Borrowing to the CFR;
   - choosing to utilize some temporary cash flow funds instead of borrowing (under borrowing); or
   - borrowing for future increases in the CFR (borrowing in advance of need).

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

9. During August, the Corporate Director decided to take advantage of a dip in PWLB rates and borrow £4m to bring the Council's total debt up to its estimated CFR. However, because of slippage in the capital programme at the end of the financial year the Council is still over borrowed at the end of March 2009 when compared to the Council's Capital Financing Requirement. The treasury position at the 31st March 2009 compared with the previous year is shown in the tables below.

	31st March 2008		**31st March 2009**	
	Principal £m	**Average Rate %**	**Principal £m**	**Average Rate %**
BORROWING				
Fixed Interest Rate Debt	238.998	5.73	238.712	5.56
Variable Interest rate Debt	16.000	4.86	20.000	6.48
Total Debt	254.998	5.67	258.712	5.62

	31st March 2008		**31st March 2009**	
	Principal £m	**Average Rate %**	**Principal £m**	**Average Rate %**
INVESTMENTS				
Fixed Interest Investments	103.418	5.94	92.000	5.57
Variable Interest Investments	11.000	6.29	21.885	5.06
Total Investments	114.418	5.95	113.885	5.46
Net Borrowing Position	140.580		144.827	

PRUDENTIAL INDICATORS AND COMPLIANCE ISSUES

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

11. Net borrowing and the Capital Financing Requirement – 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 Capital Financing Requirement for 2008/09 plus the expected changes to the Capital Financing Requirement in 2009/10

and 2010/11. The table below highlights that the Council has complied with this requirement.

	31st March 2008	31st March 2009	
	Actual **£m**	**Original Indicator** **£m**	**Actual** **£m**
Net borrowing position	140.580	155.817	144.827
Capital Financing Requirement	250.463	259.222	253.639

12. 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.

13. The Operational Boundary - is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the Boundary is acceptable subject to the Authorised Limit not being breached.

14. 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
Authorised Limit	£288.800m
Maximum gross borrowing position during 2008/09	£258.859m
Operational Boundary	£265.000m
Average Gross Borrowing position during 2008/09	£257.390m
Minimum Gross Borrowing position during 2008/09	£254.859m
Financing costs as a proportion of net revenue stream	
HRA	21.0%
General Fund	1.58%

ECONOMIC BACKGROUND FOR 2008/09

15. 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 the global economy. Underlying this has been the undercurrent of uncertainty and mistrust in the financial markets.

16. The year opened on an uncertain note. The ongoing effects of the "credit crunch" which had started in 2007 prompted the Bank of England to cut its Bank Rate by 0.25% to 5%. However, the Consumer Price Index of inflation was rising and in April

breached the 3% upper limit of the Governments' target range. Consequently rates were left on hold during the summer months because of the threat of rising inflation (commodities, food & especially oil) causing a wage/price spiral. Mid September saw a "sea change" in financial markets and economic policies. Major banks had to be bailed out, but it was the collapse of the US investment bank, Lehman Brothers, that dealt a devastating blow to the financial markets. Liquidity almost completely dried up which made it very difficult for banks to function normally. These developments culminated in the failure of the entire Icelandic banking system in early October.

17. 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:-

- A major rescue package totaling as much as £400 billion 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.

18. The New Year failed to herald a change in the fortunes of the banking sector. The Monetary Policy Committee continued to reduce interest rates in an attempt to alleviate some of the cost pressures being experienced by financial institutions and, more to the point, the business and household sectors. 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 £150 billion.

19. Aside from Bank of England assistance, the 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.

20. It was clear that the problems of the financial markets had spread to the wider economy. Economic data confirmed that the UK was in deep recession and the latest Bank of England Inflation Report (published mid February) stated that 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.

THE STRATEGY AGREED FOR 2008/09

21. The borrowing strategy for 2008/09 was set against an expected rise in long-term fixed interest rates over the medium term, with the possibility of borrowing in advance of need being considered if borrowing rates deteriorated. Money was borrowed in advance of need in 2007/08 while rates were relatively low and this was used during the year to meet part of the Council's borrowing requirement. Allowing for borrowing in advance, it was estimated that the Council would require £4.5m of new borrowing

during 2008/09.

22. The Council's investment strategy was again based on the expectation of shorter-term interest rates peaking at 5.5% in early 2008, falling to 4.8% by the end of March 2009. As a consequence it was expected that, if the opportunity arose then, investments would be made for longer periods with fixed interest rates to lock in good value and security of return, subject to the over-riding principle of good quality counterparty.

23. These strategies were set on the understanding that the Corporate Director of Resources would undertake the most appropriate form of borrowing and investments depending on the prevailing interest rates at the time.

ACTUAL DEBT MANAGEMENT ACTIVITY DURING 2008/09

24. Borrowing – A loan totaling £4.0m was drawn to finance the net capital spend and naturally maturing debt. The details of the loan were as follows:-

Lender	Principal	Fixed or Variable Rate	Interest Rate	Maturity date	Range of interest rates available during the year	
	£m		%		High %	Low %
PWLB	4.0	Fixed	4.39	31/03/2058	4.84	3.86

25. The actual interest rate on this loans of 4.39% compares with a budget assumption of borrowing at an interest rate of 4.6%.

26. Rescheduling – the loans portfolio is continuously monitored throughout the year to identify the possibility of budget savings from rescheduling loans. Interest rates were such that the cost of premium payments outweighed the savings that would accrue from any restructuring and as a consequence no restructuring was undertaken during the year.

27. Summary of Debt Transactions – the overall position of the debt activity resulted in a fall in the average rate by 0.05%, representing a net General Fund saving of £28,521 p.a.

INVESTMENT POSITION

28. The Council's investment policy is governed by ODPM (now CLG) Guidance, which is implemented in the annual investment strategy approved by Council on 27/02/2008. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

29. The Economic Background for 2008/09 (paragraphs 15 – 20) sets out the deterioration in economic conditions during this period. As a result of the economic

situation, the security of banks was called into question, resulting in the falling credit ratings for the majority of financial institutions. In response to the financial crisis, the Council amended its Investment Strategy during the year. The Upper Limit category, was increased from £12.5m to £20m, and the Middle Limit Category from £10m to £15m. These changes allowed the Council to place more funds with the larger, more secure, Building Societies, some of who had subsumed smaller societies we previously invested with. Such a change in the Treasury Management Strategy would normally require a Council decision but because of rapidly deteriorating circumstances the change was brought about under the "Urgency" rules. Details of this change, together with two minor changes that did not require Council approval, were reported to Cabinet on 4th December 2008 for information purposes.

30. 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 comprised as follows, and meet the expectations of the budget:

Balance Sheet Resources	**31st March 2008 £m**	**31st March 2009 £m**
Balances	20.404	14.325
Earmarked reserves	56.229	66.812
Provisions	.238	.238
Usable Capital Receipts	22.758	12.867
Total	**99.629**	**94.242**

31. The Council does not have the expertise or the resources to use a wide range of investment products and therefore opportunities to invest are limited to cash deposits. During the year the Council maintained an average balance of £136.5m and received an average return of 5.46% gross (5.18% once deductions for interest paid on school balances etc. have been made). The comparable performance indicator is the average 7-day LIBID rate, which was 3.57%. This compares with a budget assumption of average investment balances of £114m at 5.67% interest rate (after deductions for school balances etc).

PERFORMANCE INDICATORS SET FOR 2008/09

32. The Treasury Management service has set the following performance indicators:-
    - Debt – movement in the Council's consolidated rate of interest over the year (paragraph 27 refers);
    - Debt – rate of new borrowing taken out during the year compared to the rates that were available (paragraph 24 refers);
    - Investments-returns above the 7 day LIBID rate (paragraph 31 refers)

REGULATORY FRAMEWORK RISK AND PERFORMANCE

33. The Council's treasury management activities are regulated by a variety of professional codes and 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 2008/09);
- Statutory Instrument (SI) 3146 2003, as amended, develops 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 ODPM (now DCLG) 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.

34. The Council has complied with all 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 management practices demonstrate a low risk approach.

J Danks
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