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| **Subject:** | Annual Report on Treasury Management Activities for 2009/10 |
| **Committee:** | Audit Committee |
| **Date:** | 28 June 2010 |
| **Cabinet Member:** | Councillor Bowyer |
| **CMT Member:** | Director for Corporate Support |
| **Author:** | Sandra Wilson (Corporate Finance and Accountancy Manager) |
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| **Ref:** | Acct/SW |
| **Part:** | I |

**Executive Summary:**

In order to comply with the Code of Practice for Treasury Management, the Council is required to formally report on its Treasury Management activities for the year, providing information on the progress and outcomes against the Treasury Management Strategy. This report covers the treasury management activities for financial year 2009/10, including the final position on the statutory Prudential Indicators.

In line with the recommendations in the Revised Code of Practice, this report is this year being submitted to Audit Committee as the Committee responsible for scrutiny of the Treasury Management function.

This report is required to be submitted to full Council.

**Corporate Plan 2010-2014:**

Effective financial management is fundamental to the delivery of corporate improvement priorities. Treasury Management activity has a significant impact on the Council's activity both in revenue budget terms and capital investment and is key factor in facilitating the delivery against a number of corporate priorities.

**Implications for Medium Term Financial Plan and Resource Implications: Including finance, human, IT and land**

Into the medium and longer term the Council is facing significant pressures due to the national economic situation, the Local Government funding settlement and local demand led pressures. Indications from the new Government are that there will be a further squeeze on resources available. Effective treasury management will be essential in ensuring the council's cash flows are used to effectively support the challenges ahead.

**Other Implications: e.g. Section 17 Community Safety, Health and Safety, Risk Management, Equalities Impact Assessment, etc.**

Treasury management continues to be a high risk area. The Council continues to manage this risk by ensuring all investments are undertaken in accordance with the approved investment strategy, and keeping the Counter party list under constant review.

**Recommendations & Reasons for recommended action:**

1. Audit Committee note the Treasury Management report for 2009/10.

2. The report be referred to full Council as required by the CIPFA Treasury Management Code of Practice (TMP note 6).

3. Council be requested to approve the final Minimum Revenue Provision (MRP) Policy for 2009/10 as outlined in paragraph 7.3.

**Alternative options considered and reasons for recommended action:**

None- requirement to report to Council on the Treasury Management activities for the year.

**Background papers:**

- Treasury Management Strategy report to cabinet 10 February 2009
- 2009/10 Budget Papers – presented to Full Council 2 March 2009
- Joint Finance and Performance report to Cabinet 14 July 2009, 15 September 2009, 10 November 2009, 19 January 2010 and 16 March 2010
- Council's budget report to Cabinet 10 February 2010 and Council 3 March 2010
- Joint Finance and Performance report to Cabinet 8 June 2010.

**Sign off:**

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Fin | MC CorpF910004 | Leg/ Dem& Gov | TH 17/06 | HR | n/a | Corp Prop | n/a | IT | n/a | Strat Proc | n/a |
| Originating SMT Member: Malcolm Coe | | | | | | | | | | | |

## Annual Report on Treasury Management Activities for 2009/10

### 1. Introduction

1.1 Treasury Management in Local Government is governed by the CIPFA Code of Practice on Treasury Management in the Public Services and in this context is the "*the management of the Council's investments and cash flows, its banking and its capital market transactions; the effective control of the risks associated with those activities and the pursuit of optimum performance consistent with those risks*".

1.2 The Treasury Management Code requires public sector authorities to determine an annual Treasury Management Strategy and now, as a minimum, formally report on their treasury activities and arrangements to full Council mid-year and after the year-end. These reports enable those tasked with implementing policies and undertaking transactions to demonstrate they have properly fulfilled their responsibilities, and enable those with ultimate responsibility/governance of the treasury management function to scrutinise and assess its effectiveness and compliance with policies and objectives.

1.3 This report outlines the Treasury Management activities in 2009/10, providing information on progress and outcomes against the approved strategy.

1.4 The responsibility for implementing and monitoring Treasury Management polices and practices and for the execution and administration of Treasury Management decisions is delegated by the Council to its Section 151 Officer – the Director for Corporate Support Services, and is overseen by a Treasury Management Board consisting of senior officers of the Council and the portfolio Member for Finance, Property, People and Governance. Treasury Management activities are reported to Cabinet as part of the bi-monthly finance and performance reporting process.

1.5 The Council works closely with its treasury management advisors Arlingclose who assist the Council in formulating views on interest rates when determining the treasury management strategy, regular updates on economic conditions and interest rate expectations, and advice on specific borrowing and investment decisions.

1.6 This report:

a) is prepared in accordance with the revised CIPFA Treasury Management Code and the revised Prudential Code;
b) presents details of capital financing, borrowing, debt rescheduling and investment transactions;
c) reports on the risk implications of treasury decisions and transactions;
d) gives details of the outturn position on treasury management transactions in 2009/10;
e) confirms compliance with treasury limits and Prudential Indicators.

1.7 In accordance with Treasury Management Practice (TMP) note 6, the report is required to be presented to full Council.

## 2. Revisions to the CIPFA Treasury Management and Prudential Codes, CLG Guidance on Investments

2.1 In November 2009 CIPFA released the revised Code of Practice for Treasury Management in the Public Services and accompanying Guidance Notes and the revised Prudential Code for Capital Finance in Local Authorities. The CLG also issued revised Guidance on Local Authority Investments for English authorities. The revised Codes/Guidance re-emphasise an appropriate approach to risk management, particularly in relation to the security and liquidity of invested funds. Authorities were also henceforth required to demonstrate value for money when borrowing in advance of need and ensure the security of such funds. Authorities are now also required to have a separate body or committee responsible for the scrutiny of the treasury function.

2.2 The Council has revised its treasury policy and will be revising its practices documentation to take account of the requirements and changes in the revised Codes and Guidance. The Audit Committee is now responsible for the scrutiny of the treasury management function and Members of the Audit Committee attended a training seminar in January 2010 in order to enable them to effectively undertake the scrutiny role.

## 3. The Economy and Events in 2009/10

3.1 Before reviewing the Council's performance for the year it is appropriate to outline the national and economic background within which Council Officers operated during 2009/10.

3.2 A more detailed review has been provided by the Council's advisors, Arlingclose, and is attached at Appendix 1. The key financial issues are outlined below.

3.3 In order to stimulate growth, the Bank of England maintained the Bank Rate at 0.5% throughout the year. The Bank also took extreme measures on an extraordinary scale to revive the economy through its Quantitative Easing (QE) programme. Financed by the issuance of central bank reserves QE was initially announced at £75bn, and then extended in stages to £200bn.

3.4 The November 2009 Budget was primarily about public debt. The Chancellor's forecast for net public sector borrowing in 2009/10 was £175bn or 12.4% of GDP. Gross gilt issuance was expected to hit a quite staggering £220bn in 2009/10. Standard & Poor's responded to the debt that the UK government was building up and a lack of a credible plan to reduce the debt burden by changing the UK's rating outlook from stable to negative.

3.5 LIBOR and LIBID rates (i.e. the rates at which a banks are willing to borrow from and lend to other banks) slowly moved lower towards the Bank Rate of 0.5%.

3.6 UK Government Gilts were the main beneficiary of the economic downturn and they also formed the significant bulk of the QE purchases and are thought to have pushed gilt yields, and consequently the cost of borrowing, lower by 0.5%.

3.7 Appendix 2 provides details of the Interest rates during the year.

## 4. The Council's Strategy for 2009/10

4.1 The 2009/10 Treasury Management Strategy was originally approved by the Council at its meeting of 2 March 2009. At that time, the economic interest rate view of the Council's treasury advisors, Arlingclose, was that rates were set to remain low with a high probability of zero or near zero interest rates. Market volatility was forecast to remain high, risk appetite at a low ebb, and markets were expected to continue in 'capital preservation mode' into early 2009.

4.2 In the light of the financial climate and falling interest rates, the Council strategy for 2009/10 was to continue to reduce the underlying level of borrowing by repaying borrowing from maturing investments and surplus cash balances. Capital expenditure levels, market conditions and interest rate levels were to be monitored during the year in order to minimise borrowing costs over the medium to longer term. A prudent and pragmatic approach to any new borrowing, both in terms of temporary borrowing to cover cash flow and longer term to finance the capital programme, was to be maintained to minimise borrowing costs without compromising the longer-term stability of the portfolio, consistent with the Council's Prudential Indicators.

## 5. Review of the Council's Performance 2009/10

5.1 Table 1 shows the Council's overall Treasury Portfolio at the end of 2009/10 compared to 2008/09.

**Table 1**

| 31/3/2009 £m | Average Interest rate % | | 31/3/2010 £m | Average Interest rate % |
|---|---|---|---|---|
| | | External Borrowing Long-term: | | |
| 152.500 | 5.3769 | PWLB | 28.889 | 5.8084 |
| 130.000 | 3.9730 | Market | 130.000 | 4.4202 |
| 0.083 | 3.4458 | Bonds | 0.083 | 3.5574 |
| 87.800 | 0.7633 | Temporary Borrowing | 73.650 | 0.3685 |
| **370.383** | **3.7901** | **Total PCC Borrowing** | **232.622** | **3.3095** |
| 35.351 | 5.4770 | Devon Debt | 33.937 | 5.2395 |
| **405.734** | **3.9370** | **Total Loan debt** | **266.559** | **3.5552** |
| | | Long-term liabilities | | |
| 36.302 | 8.7300 | PFI Schemes | 33.156 | 8.7300 |
| **442.036** | | **Total External Debt** | **299.715** | |
| **(213.800)** | 5.0816 | **Total Investments** | **(153.051)** | 2.1000 |
| **228.239** | | **Net Borrowing/(Net Investment) Position** | **146.664** | |

5.2 The 2009 SORP has introduced changes to the accounting for PFI schemes, and now requires qualifying schemes to be included within the Council's Balance Sheet. The Council is however required to set up a matching long term liability reflecting the outstanding payments to the provider over the term of the contract. This liability is seen as a credit arrangement and increases the Council's total debt and must be taken into account within the statutory borrowing limits. The Council has one PFI scheme, the contract with Pyramid Consortium to build and run the schools at Woodview campus and Riverside.

**Borrowing 2009/10**

5.3 Under Section 3 of the Local Government Act 2003 and supporting regulations the Council must determine and keep under review how much it can afford to borrow. The Council is required to set two limits:

- The Authorised Limit
- The Operational Boundary

5.4 The borrowing limits for 2009/10, originally approved by Council in March 2009, as updated for the inclusion of the PFI scheme in March 2010, were as follows:

- Authorised limits £495m
- Operational Boundary £465m

5.5 The maximum borrowing outstanding in the year was £434.038m on 1 April 2009. (including £33.156m for the PFI scheme). This was within both the authorised limit and the operational boundary.

5.6 Table 2 shows the movement in the borrowing portfolio during the year.

**Table 2**

| | Balance at 01/4/2009 £m | % | Maturing loans £m | Premature redemptions £m | New Borrowing £m | Balance at 31/3/2010 £m | % |
|---|---|---|---|---|---|---|---|
| Fixed rate loans - PWLB | 152.500 | 5.38 | (21.240) | (102.371) | 0 | 28.889 | 5.81 |
| Fixed rate loans – Market | 130.000 | 3.97 | 0 | 0 | 0 | 130.000 | 4.42 |
| Temporary Borrowing | 87.800 | 0.76 | (199.450) | 0 | 185.300 | 73.650 | 0.37 |
| Local bonds | 0.083 | 3.45 | 0 | 0 | 0 | 0.083 | 3.56 |
| **Total Borrowing** | **370.383** | **3.79** | **(220.690)** | **(102.371)** | **185.300** | **232.622** | **3.31** |

5.7 New borrowing in year

5.7.1 The Council did not undertake any new long term borrowing during the year, but took advantage of low rate short term loans and internal balances to replace maturing loans and meet capital financing and cash flow requirements.

5.7.2 Borrowing at the 31 March 2010 included additional short-term loans taken during February and March deposited in call accounts to allow for available funds to cover the possible repayment of the pre LGR debt, administered by Devon County Council, during 2010/11.

5.8 Debt Repayment

5.8.1 At the start of the year a PWLB loan of £11m was repaid using a mixture of maturing deposits and short-term borrowing. The Council received £0.101m in terms of discounts from the early repayment of the loan and in accordance with capital financing regulations this will be spread over 10 years.

5.8.2 As part of the Housing stock transfer, the Department of Communities and Local Government (DCLG) repaid the HRA proportion of the Council's Public Works Loan Board debt totalling £91.37m, together with an early redemption premium of £25.94m. This has led to a significant reduction in the Council's debt, and whilst the reduction in debt is a positive step, the Council's revised debt portfolio has a significant proportion of market loans which will need to be addressed over time. Overall there has been a reduction in borrowing of £137.761m since the 1 April 2009 reflecting the Council's policy to reduce debt.

5.9 Debt rescheduling

5.9.1 The main objective of debt rescheduling is to reduce the Council's overall exposure to the risk of interest rate movements, to lower the long-term interest charges paid on its debt, to smooth the maturity profile without compromising the overall longer-term stability, or to alter its volatility profile (i.e. exposure to variable rate debt).

5.9.2 Debt rescheduling became more challenging after the introduction by the PWLB of a separate, lower set of repayment rates in November 2007. This increased the costs associated with the premium payable and diminished the discount receivable, thus reducing the cost savings achievable. However the volatility of PWLB rates still give opportunities to repay/reschedule debt. As stated above, £11m of PWLB debt was repaid in 2009/10 replacing the loan with short-term rolling debt and use of cash flow. This achieved in year savings of £0.380m with estimated full year savings in 2010/11 of £0.460m.

5.10 Overall Debt Performance for the year

The average interest rate on the debt has reduced over the course of the year from 3.7901% to 3.3095%. This rate reflects the position at the end of each financial year (i.e. at 31 March for 2009 and 2010). The reduction in rates is due to the repayment of PWLB loans replaced with considerably lower rate short-term temporary borrowing and any additional borrowing requirement in the year taken in short-term borrowing. Loan transactions were taken at various times throughout the year at various rates and, taking all transactions in the year, the overall weighted average borrowing rate for 2009/10 was 4.31% compared with a rate of 4.51% for 2008/09.

## Investments 2009/10

5.11 The CLG's Guidance on Investments, revised during 2009/10, reiterated security and liquidity as the primary objectives of a prudent investment policy. Although the Guidance becomes operative on 1 April 2010, its principal recommendations run parallel to the credit risk management requirements in the revised Treasury Management Code. In the revised Guidance, Specified Investments are those made with a body or scheme of "high credit quality". Both the Guidance and the revised Treasury Management Code emphasise that counterparty credit criteria should not rely on credit ratings alone but should include a wider range of indicators. The revised Code nonetheless requires that ratings assigned by all three rating agencies – Fitch, Moody's and Standard & Poor's – be taken into account and the lowest rating be used.

5.12 Credit criteria, counterparty risk and selection: In determining suitable investment counterparties, the Council was, in any event, already taking into consideration economic and financial information as well as evaluating alternative assessments of credit strength (for example, potential sovereign support, sovereign strength as evidenced by the ratings and GDP, sovereign and counterparty credit default swaps).

5.13 Managing counterparty risk continued to be the Council's overwhelming investment priority. Financial markets remained in a fragile state particularly at the beginning of 2009/10. Against this backdrop, the Council continued to place investments with a small, select list of counterparties.

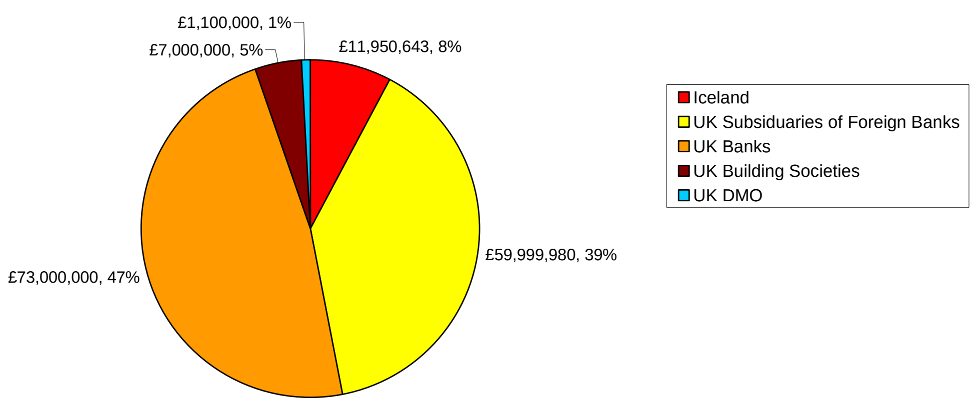
5.14 New investments in the year were restricted to the DMO, investments with banks and building societies which are Eligible Institutions under the UK Government's 2008 Credit Guarantee Scheme and with a long-term AA- (AA minus) rating. In the main the Council made use of reserve accounts, allowing instant access to funds. The Council accepted the diminution in investment return from investing with highly rated counterparties as an acceptable risk-reward trade-off. Table 3 below shows the criteria and institutions used during 2009/10.

**Table 3**

| Financial Asset Category | Criteria | Maximum Investment | Maximum Investment Term |
|---|---|---|---|
| Government Debt Management Office (DMO) | UK Government | £50m | 1 year |
| UK banks and building societies supported by Government capitalisation or have access to the credit guarantee scheme: | F1+ Short term<br>AA -or higher long term:<br>Barclays<br>HSBC<br>Lloyds Banking Group<br>Royal bank of Scotland<br>Santander UK (PLC)<br>(Banco Santander Group)<br>Nationwide | £30m | 1 year |
| Local Authorities | Unitary Councils<br>County Councils<br>Metropolitan Councils<br>London Borough Councils | £5m | 1 year |
| Nationalised Banks | UK Government:<br>Northern Rock | £30m | 3 Months |
| UK banks and building societies supported by Government capitalisation or have access to the credit guarantee scheme | F1+ short term<br>AA -or higher long term:<br>Clydesdale | £30m | 1 Month |

5.15 At 31 March 2010 the Council's investments stood at £153.051m. The pie chart below analyses the investments by country/sector.

**PCC DEPOSITS BY COUNTRY AT 31st MARCH 2010 - Total Deposits £153,050,623.26**



5.16 Investments are made short term to cover cash flow and liquidity requirements and longer term to maximise and guarantee future income.

Overall Investment performance for the year

5.17 The UK Bank Rate was maintained at 0.5% from March 2009 onwards. Money market rates soon fell to and remained at historic lows. Whilst existing investments provided some insulation against falling rates, new investments could only be made at the prevailing lower rates of interest. This has had a significant impact on investment income.

5.18 During 2009/10 the Council invested for a range of periods from overnight to 364 days, dependent on the Council's cash flows, Officer's interest rate view and the interest rates on offer and the economic climate. The Council's treasury management officers work to a benchmark rate of return, the 7 day London Interbank Bid (LIBID) rate – which is the rate which can be achieved on the London interbank market for cash deposits of 7 days and is regarded as the standard benchmark. The 7 day rate is calculated on a daily basis and averaged for the year. Table 4 below compares the average return achieved by the in-house team with the benchmark. An average rate of 1.3% was achieved for new investments in the year against a budget of 1%.

**Table 4**

| | Average Investment | Benchmark Rate % | Actual Return % |
|---|---|---|---|
| Internally Managed | £153.112m | 0.45 | 3.4443 |

The table shows that the internal performance exceeded the benchmark for the year, despite the restricted investment counterparty list.

Icelandic Banks Update

5.19 The latest position on the recoveries of monies invested in the Icelandic banks is as follows:

5.19.1 Heritable Bank £3m

During the year the Council received 3 dividend payments from the administrators of heritable bank, totaling £1,049,400, plus interest of £53,503. This represents a recovery rate of 34.98%. Based on current projections from the administrators a total recovery of between 79% to 85% is expected with dividends continuing on a quarterly basis until September 2012.

5.19.2 Glitnir £6m

The Winding Up Board for Glitnir have not accepted local authority deposits as “priority status” claims. The Council has through the Director of Corporate Support and Assistant Director of Democracy and Governance instructed Bevan Brittan Solicitors (and through them Icelandic and English Counsel) to act for the authority in pursuing our claim through the Icelandic courts. Bevan Brittan, (through the auspices of the LGA) are also acting for other public bodies allowing us to avoid duplication and share costs. This process is expected to take some time with a final ruling on our priority status unlikely to be forthcoming until 2011. The anticipated recovery for priority status remains at 100% but falls to 29% for non-priority claims.

5.19.3 Landsbanki £4m

Unlike Glitnir, the Winding up Board for Landsbanki have agreed to the priority creditor status for local authorities but have received a number of objections to this decision from other creditors which will need to be resolved through the Icelandic courts. As with Glitnir, the Council has instructed Bevan Brittan Solicitors (and through them Icelandic and English Counsel) to act for the authority in pursuing our claim through the courts. The latest creditor reports indicate a recovery of 95% for priority claims and 38% for non-priority claims. No payments will be made until the litigation has been concluded, which is unlikely to be until 2011.

5.19.4 Capitalisation Directions

On 31 January the Council received confirmation that the Capitalisation Direction application for the potential Icelandic bank losses had been approved in the sum of £5.7m. Although the Council is not required to account for any losses in its accounts until 2010/11 it can use the Capitalisation Direction to bring the losses into its accounts during 2009/10, and this has been approved by Cabinet. By taking this action, the Council will minimise the impact of any final loss by spreading the loss over a 20 year period.

5.19.5 The situation with regard to the recovery of monies invested in Icelandic Banks continues to be subject to much uncertainty as outlined above. The impairment charge made to the accounts for 2009/10 was £5.903m, however the impairment charge required for accounting purposes should in no way be taken to assume this will be the final outcome. The Council, working with the LGA and Bevan Brittan remain committed to maximising the recovery of our investments.

## 6. Revenue Implications of Treasury Management

6.1 The expenditure arising from the Council's borrowing and lending accrues to the revenue accounts. This includes interest payable and receivable, the minimum revenue provision (for debt repayment), and premiums and discounts written out to revenue from previous debt rescheduling. A proportion of interest payable was recharged to the HRA up to the stock transfer date, whilst some of the interest receivable is passed on to specific accounts where this interest has accrued from the investment of surplus balances for these services. The balance (net cost) is met by the General Fund. Table 5 below shows the income and expenditure arising from these transactions in 2009/10.

6.2 Overall there was a net adverse variation on the capital financing budget of £0.683m for the year.

### Summary of Capital Financing Costs 2009/10

**Table 5**

| | 2009/10 Budget £000 | 2009/10 Outturn £000 | Variance £000 |
|---|---|---|---|
| External Interest payments | 11,909 | 11,507 | (402) |
| Interest payable (PFI) | 0 | 2,962 | 2,962 |
| External Interest received | (5,031) | (5,353) | (322) |
| Recharged to HRA | (2,019) | (1,908) | 111 |
| Interest transferred to other accounts | 400 | 187 | (213) |
| Premiums / Discounts written out to Revenue | (183) | (189) | (6) |
| Debt Management Expenses | 56 | 115 | 59 |
| **Treasury Management Cost** | **5,132** | **7,321** | **2,189** |
| Minimum Revenue Provision | 6,444 | 8,081 | 1,637 |
| Minimum Revenue Provision (PFI) | 0 | 566 | 566 |
| Devon County Council Residual Debt Charges | 3,354 | 3,229 | (125) |
| Recharges for unsupported borrowing | (1,533) | (1.300) | 233 |
| Recovered from trading Accounts | (2,605) | (2,894) | (289) |
| PFI Grant | 0 | (3,528) | (3,528) |
| **Net Cost to General Fund** | **10,792** | **11,475** | **683** |

## 7. Minimum Revenue Provision (MRP)

7.1 The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 (SI 2008/414) place a duty on local authorities to make a prudent provision for debt redemption. The Regulations outline MRP options as follows:

Option 1: Regulatory Method
Option 2: CFR Method
Option 3: Asset Life Method
Option 4: Depreciation Method

7.2 Options 1 and 2 can be used on all capital expenditure incurred before 1st April 2008 and on Supported Capital Expenditure on or after that date. Options 3 and 4 are considered prudent options for Unsupported Capital Expenditure on or after 1st April 2008 and can also be used for Supported Capital Expenditure whenever incurred.

7.3 The Council's MRP policy for 2009/10 was approved by full Council on 2 March 2009, and subsequently updated on 6 July 2009. Revised Capital Finance Regulations were subsequently issued in March 2010, effective for financial year 2009/10. These regulations introduced a further amendment to the MRP options for PFI schemes, aimed at mitigating the financial impact of bringing PFI schemes on balance sheet. The amendment effectively allows the annual MRP provision for PFI schemes to match the annual principal repayment for the associated deferred liability. Council is therefore asked to approve the final MRP policy for 2009/10 as follows:

Supported Borrowing
For borrowing supported by Revenue Support Grant the Council will continue to use the current method of 4% of the adjusted Non-HRA capital financing requirement.

Unsupported Borrowing
For new borrowing under the prudential system for which no Government support is being given and is therefore self-financed, MRP will be made in equal annual instalments over the life of the asset.

Capitalisation Directions
For capitalisation directions on expenditure incurred since 1 April 2008 MRP will be made in equal annual instalments over 20 years in line with DCLG guidance.

PFI/Leases
MRP in respect of PFI and leases brought on Balance Sheet under the 2009 SORP and IFRS will be based on a charge equal to the amount that has been taken to the Balance Sheet to reduce the liability.

7.4 In all cases MRP commences in the financial year following the one in which the expenditure is incurred.

## 8. Prudential Indicators

8.1 Under the arrangements set out in the Prudential Code for Capital Finance in Local Authorities, individual authorities are responsible for deciding the level of their affordable borrowing, having regard to the Code, and for establishing a range of prudential indicators covering borrowing limits and other treasury management measures. The prudential Indicators for 2009/10 were approved by Council on 2 March 2009 updated for the PFI scheme on 1 March 2010. The final position on the indicators for 2009/10 is outlined in Appendix 3.

## 8. Balanced Budget

8.1 The Council complied with the Balanced Budget requirement.

## 9. External Service Providers

9.1 Arlingclose is appointed as the Council's treasury management advisor. The Council is clear as to the services it expects and is provided under the contract. The service provision is comprehensively documented. The Council paid a sum of £20,000 in 2009/10 for this service.

9.2 The Council is also clear that overall responsibility for treasury management remains with the Council.

## 10. Training

10.1 CIPFA's revised Code requires the Director of Corporate Support to ensure that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities.

10.2 The CLG's revised Investment Guidance also recommends that a process is adopted for reviewing and addressing the needs of the authority's treasury management staff for training in investment management.

10.3 The Council commissioned a Treasury Management awareness and training session from external consultants Griffiths Morley and this was delivered on 22 January 2010. The training was attended by all existing members of the Audit Committee and several members from Cabinet and scrutiny panels.

## 11. Recommendation

11.1 Audit Committee note the Treasury Management report for 2009/10.

11.2 The report be referred to full Council as required under the CIPFA Treasury Management Code of Practice (TMP note 6).

11.3 Council be requested to approve the final Minimum Revenue Provision (MRP) Policy for 2009/10 as outlined in paragraph 7.3.

**Appendix 1**

# Arlingclose Review of the Economy for 2009/10

## Economic Outlook for 2009/10

At the time of determining the Treasury Strategy Statement for 2009/10 in January 2009, the outlook for the economy and interest rates was as follows:

The UK, Eurozone and US economies were contracting, globally economies faced a prolonged recession or period of weakness following the financial market meltdown in the autumn of 2008. Availability of credit was restricted as banks undertook to repair their balance sheets. This exacerbated the slowdown as finance for small businesses effectively came to a standstill.

Asset values were falling and were forecast to drop further, particularly those which related to commodities and housing. The increase in food and energy inflation which had exerted a powerful squeeze on real incomes in 2008 was, however, expected to fade in 2009. Wage inflation was forecast to remain low and the labour market to remain weak; the threat of unemployment was likely to influence consumers to scale back spending and save instead.

The UK Bank Rate had been cut to 0.5% and in March 2010 the Bank of England announced its initial £75bn of Quantitative Easing (QE). There remained a sizeable gap between short-dated LIBOR rates (i.e. the rates at which a banks are willing to borrow from other banks) and the Bank Rate; this gap was forecast to narrow. Gilts were expected to benefit from QE, resulting in lower yields.

## The Economy and Events in 2009-10

After the particularly torrid economic recession and a severe downturn in growth that extended into early 2009, there were reports of nascent recovery. The Bank of England forecast UK growth to fall by 3.9% in 2009, whilst inflation was forecast to be heading lower and staying lower for longer. The depth of the recession was borne out by the 5.9% year-on-year fall in GDP recorded at the end of the second quarter of 2009. The service sector - the dominant element of UK economy - also stalled for much of early 2009 despite a number of optimistic surveys to the contrary. Green shoots of recovery were finally evident in the final quarter of 2009 with growth registering 0.4% for the quarter.

In order to stimulate growth, the Bank of England maintained the Bank Rate at 0.5% throughout the year. The Bank also took extreme measures on an extraordinary scale to revive the economy through its **Quantitative Easing** (QE) programme. Financed by the issuance of central bank reserves QE was initially announced at £75bn, and then extended in stages to £200bn.

The Bank appears to have successfully staved off the very real risk of deflation. The increased supply of money in the system due to QE did not however translate into an increase in the movement of money in the system as banks are still unwilling to lend, and consumers are unwilling to borrow at pre-crisis levels.

The housing market showed some signs of stability but increases in house prices were modest. Nationwide House prices registered a year on year growth of 9% at the end of March 2010.

Consumer Price Inflation, having hit a high of 5.2% in September 2008, began the year at 3.2% (Feb 2009 data), fell to a low of 1.1% in September 2009 as the oil, commodity, utility and food prices (the main drivers of high inflation in 2008) fell out of the year-on-year statistical calculations. Thereafter, inflation pushed higher with rising oil and transport costs and VAT reverting to 17.5%. CPI at year end was 3.0% (Feb 2010 data).

Companies and households on the whole reduced rather than increased their levels of debt. Credit remained scarce and at a premium, and certainly as compared to that available two years earlier. Businesses retrenched rather than hired workers and unemployment rose rapidly to just under 2.5 million. Against this background, wage growth was muted.

The November 2009 Budget was primarily about public debt. The Chancellor's forecast for net public sector borrowing in 2009/10 was £175bn or 12.4% of GDP. Gross gilt issuance was expected to hit a quite staggering £220bn in 2009/10. Standard & Poor's responded to the debt that the UK government was building up and a lack of a credible plan to reduce the debt burden by changing the UK's rating outlook from stable to negative.

The outlook for 2010 was therefore for a period of slow and patchy growth in the economy accompanied by stubbornly high unemployment. The UK fiscal deficit remained acute. Cuts in public spending and tax increases were becoming inevitable and a credible plan to reduce the deficit was urgently required after the May General Election, the absence of which increased the potential of a sovereign downgrade. The likelihood of a hung parliament had grown and had the potential of being disruptive to financial markets.

## Gilts and Money Market Rates

LIBOR and LIBID rates (i.e. the rates at which a banks are willing to borrow from and lend to other banks) which had been stubbornly high in early 2009, slowly moved lower towards the Bank Rate of 0.5%.

UK Government Gilts were the main beneficiary of the economic downturn (it is an asset class that responds positively to poor economic news); they also formed the significant bulk of the QE purchases and are thought to have pushed gilt yields, and consequently the cost of borrowing, lower by 0.5%.

**Appendix 2**

## Economic and Money Market Data, PWLB Rates

### 1. Bank Rate, Money Market Rates

| | | Bank Rate | | O/N LIBID | 7-day LIBID | 1-month LIBID | 3-month LIBID | 6-month LIBID | 12-month LIBID | 2-yr SWAP Bid | 3-yr SWAP Bid | 5-yr SWAP Bid |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | |
| Minimum | | 0.50 | | 0.200 | 0.250 | 0.250 | 0.350 | 0.490 | 0.830 | 1.517 | 2.050 | 2.808 |
| **Average** | | **0.50** | | **0.368** | **0.390** | **0.470** | **0.695** | **0.928** | **1.283** | **1.914** | **2.540** | **3.254** |
| Maximum | | 0.50 | | 0.750 | 0.520 | 1.050 | 1.500 | 1.800 | 2.150 | 2.447 | 3.117 | 3.770 |
| Spread | | | | 0.550 | 0.270 | 0.800 | 1.150 | 1.310 | 1.320 | 0.930 | 1.068 | 0.963 |

### 2. PWLB Borrowing Rates – Fixed Rate, Maturity Loans

| | 1 year | 4½-5 yrs | 10-10½ yrs | 19½-20 yrs | 29½-30 yrs | 39½-40 yrs | 49½-50 yrs |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| Low | 0.68 | 2.47 | 3.30 | 4.01 | 4.10 | 4.13 | 4.17 |
| **Average** | **0.90** | **2.89** | **3.93** | **4.45** | **4.50** | **4.52** | **4.52** |
| High | 1.23 | 3.29 | 4.42 | 4.84 | 4.80 | 4.83 | 4.84 |

### 3. PWLB Repayment Rates - Fixed Rate, Maturity Loans

| | 1 year | 4½-5 yrs | 10-10½ yrs | 19½-20 yrs | 29½-30 yrs | 39½-40 yrs | 49½-50 yrs |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| Low | 0.43 | 1.83 | 2.93 | 3.74 | 3.84 | 3.79 | 3.73 |
| **Average** | **0.65** | **2.47** | **3.68** | **4.19** | **4.24** | **4.15** | **4.07** |
| High | 0.98 | 2.88 | 4.17 | 4.59 | 4.55 | 4.47 | 4.40 |

### 4. PWLB Variable Rates

| | 1-M Rate | 3-M Rate | 6-M Rate |
|---|---|---|---|
| | | | |
| Minimum | 0.5500 | 0.5500 | 0.5500 |
| **Average** | **0.6303** | **0.6414** | **0.6697** |
| Maximum | 0.8000 | 0.8500 | 0.9000 |

**Appendix 2**

## Economic Data

| **Inflation** | **CPI** | **RPI** |
|---|---|---|
| **Feb-09** | 3.2 | 0.0 |
| | | |
| **Mar-09** | 2.9 | -0.4 |
| **Apr-09** | 2.3 | -1.2 |
| **May-09** | 2.2 | -1.1 |
| **Jun-09** | 1.8 | -1.6 |
| **Jul-09** | 1.8 | -1.4 |
| **Aug-09** | 1.6 | -1.3 |
| **Sep-09** | 1.1 | -1.4 |
| **Oct-09** | 1.5 | -0.8 |
| **Nov-09** | 1.9 | 0.3 |
| **Dec-09** | 2.9 | 2.4 |
| **Jan-10** | 3.5 | 3.7 |
| **Feb-10** | 3.0 | 3.7 |
| **Mar-10** | Not yet available | |
| | | |
| **Growth** | **Q-o-Q** | **Y-o-Y** |
| **Q1 2009** | -2.6 | -5.4 |
| **Q2 2009** | -0.6 | -5.9 |
| **Q3 2009** | -0.3 | -5.3 |
| **Q4 2009** | 0.4 | -3.1 |

**Appendix 3**

## Prudential Indicators 2009/10

There is a requirement under the Local Government Act 2003 for local authorities to have regard to Cipfa's Prudential Code for Capital Finance in Local Authorities (the "Cipfa Prudential Code") when setting and reviewing their Prudential Indicators. The Code requires a report to full Council on compliance with the prudential indicators set.

The Council's Prudential Indicators are outlined in Annex 1. The following comments explain in more detail the purpose of each indicator.

### Estimates of Capital Expenditure:

This indicator is set to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council Tax.

The final spend on the capital programme for 2009/10 was £92.221m.

### Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the Council's underlying need to borrow for a capital purpose. The calculation of the CFR is taken from the amounts held in the Balance Sheet relating to capital expenditure and its financing. It is an aggregation of the amounts shown for Fixed and Intangible assets, the Revaluation Reserve, the Capital Adjustment Account, Government Grants Applied and any other balances treated as capital expenditure.

The Prudential Code provides the following statement as a key indicator of prudence: "in order to ensure that over the medium term net borrowing will only be for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years."

### Authorised Limit and Operational Boundary for External Debt:

The Council has an integrated treasury management strategy and manages its treasury position in accordance with its approved strategy and practice. Overall borrowing will therefore arise as a consequence of all the financial transactions of the Council and not just those arising from capital spending reflected in the CFR. There are two borrowing limits specified within the Code.

The Authorised Limit
This is the absolute borrowing limit beyond which any borrowing is prohibited until revised by the authority. It is measured on a daily basis against all external borrowing items on the Balance Sheet (i.e. long and short term borrowing, overdrawn bank balances and long term liabilities. This Prudential Indicator separately identifies borrowing from other long term liabilities such as finance leases. It is consistent with the Council's existing commitments, its proposals for capital expenditure and financing and its approved treasury management policy statement and practices.

The Authorised Limit is set on the estimate of the most likely, prudent but not worst case scenario with sufficient headroom over and above this to allow for unusual cash movements.

The Authorised Limit is the statutory limit determined under Section 3(1) of the Local Government Act 2003 (referred to in the legislation as the Affordable Limit).

The Operational Boundary
This limit is intended to cover the probable borrowing needs of the authority during the year. It is a focus for day to day Treasury Management and a means by which the authority manages its external debt within the self imposed Authorised limit. It is lower than the Authorised limit because cash flow variations may lead to the occasional breach of this indicator.

**Upper Limits for Fixed and Variable Interest Rates**

These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates. This Council calculates these limits as:

- Fixed rate interest rate exposure: net fixed rate debt (fixed rate debt less fixed rate investments) as a % of total net debt (total debt less total investments)
- Variable interest rate exposure: net variable rate debt (variable rate debt less variable rate investments) as a % of total net debt (total debt less total investments

The fixed rate indicator generally remains high reflecting historical policy to take long term fixed rate debt and short term investments (investments for less than 1 year are classified as variable rate).

Borrowing at fixed rates for long periods can give the opportunity to lock into low interest rates and provide stability but risks missing possible opportunities to borrow at low rates in the medium term, or to convert short term loans into long term if long term rates were to fall.

The upper limit for variable rate exposure was set to ensure that the Council is not exposed to interest rate rises which could adversely impact on the revenue budget. The limit allows for the use of variable rate debt to offset exposure to changes in short-term rates on investments. The updated upper limit of 310% on fixed interest rate exposure allowed for periods when short term deposits would exceed variable rate debt due to balances/cashflow.

The actual fixed interest rate exposure reached a high of 320% on 15 December 2009 due to the receipt from the sale of Citybus on 3 December and a large amount of grant receipts received on 15 December. These funds were deposited in short-term investments reducing net debt and thus increased the fixed rate proportion of this net debt. The breach lasted 2 days after which the exposure to fixed rate date fell to 275% and ended the year at 110%.

**Upper Limit for sums invested over 364 days:**

The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Council having to seek early repayment of the sums invested.

**Ratio of Financing Costs as a % of Net Revenue Stream:**

This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet borrowing costs.

The ratio is based on the cost of interest on borrowing and the minimum revenue provision, less Interest and Investment income. In Plymouth's case, a proportion of the cost comes from debt arising from Local Government Reorganisation, which is managed by Devon County Council. The Council is liaising with Devon to take this debt back in house during 2010/11.

**Incremental Effect of Additional Programme on Council Tax**

This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax.

During 2009/10 the strategy was to minimise new long term borrowing, with the borrowing requirement being met as far as possible from cash flow and balances. This has resulted in a negative impact on the Council tax in 2009/10.

**Maturity Structure of Fixed Rate borrowing:**

This indicator highlights the existence of any large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates and is designed to protect against excessive exposures to interest rate changes in any one period, in particular in the course of the next ten years.

It is calculated as the amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate. The maturity of borrowing is determined by reference to the earliest date on which the lender can require payment. The repayment of the majority of PWLB loans over the last 12 months have resulted in an high proportion of Lobo (lenders Option, Borrowers Option) loans which may be subject to rate change or repayment at specified intervals. On specified dates the Lender has the option to vary the rate. If the option is taken the Council (Borrower) has the option to repay the loan. Therefore the loan may be subject to repayment on a number of occasions throughout the life of the loan. These repayment possibilities are included in the limits set for the maturity of fixed rate borrowing.

## 2009/10 TREASURY MANAGEMENT STRATEGY - PRUDENTIAL INDICATORS

| PRUDENTIAL INDICATOR | 2009/10 Approved | 2009/10 Update | 2009/10 Actual |
|---|---|---|---|
| | £M | £M | £M |
| **AFFORDABLE BORROWING LIMITS** | | | |
| **Estimated Capital expenditure** | | | |
| Non - HRA | 84.691 | 84.030 | 83.660 |
| HRA | 7.222 | 7.991 | 8.561 |
| **Total** | **91.913** | **92.021** | **92.221** |
| **Capital Financing Requirement - As at 31st March** | **209.036** | **239.113** | **248.388** |
| **Authorised Limit for External Debt** | | | |
| Borrowing | 460 | 460 | 405.7 |
| Other Long Term Liabilities (PFI) | 0 | 35 | 33.2 |
| **Total** | **460** | **495** | **438.9** |
| **Operational Boundary** | | | |
| Borrowing | 430 | 430 | 405.7 |
| Other Long Term Liabilities (PFI) | 0 | 35 | 33.2 |
| **Total** | **430** | **465** | **438.9** |
| **Limit for Fixed Interest Rate Exposure** | | | |
| Net Fixed Rate (Borrowing less investments) | 200% | 310% | 320% |
| **Limit for Variable Rate Exposure** | | | |
| Net Variable Rate (borrowing less investments) | 60% | 60% | -3% |
| **Upper Limit for sums Invested over 364 days** | £60m | £60m | £47m |
| **Capital Financing Cost as a % of Revenue Stream** | % | % | % |
| General Fund | | | |
| - Plymouth Debt | 6.12 | 6.41 | 6.34 |
| - Devon Managed Debt | 1.71 | 1.67 | 1.64 |
| **Total** | 7.83 | 8.08 | 7.98 |
| Housing Revenue Account | 28.69 | n/a | n/a |
| **Incremental Effect of Additional Programme on Council Tax (Band D p.a)** | **£0.75** | **-£1.30** | **-£2.59** |

| **Fixed Rate Borrowing Maturity Limits for 2009/10** | **2009/10 Upper Limit** | **2009/10 Lower Limit** | **2009/10 Actuals Upper Limit** | **2009/10 Actuals Lower Limit** |
|---|---|---|---|---|
| Under 12 months | 60% | 0% | 53.49% | 14.39% |
| 12 months and within 24 months | 60% | 0% | 49.64% | 13.23% |
| 24 months and within 5 years | 30% | 0% | 13.92% | 3.51% |
| 5 years and within 10 years | 25% | 0% | 4.54% | 1.35% |
| 10 years and within 20 years | 60% | 0% | 42.30% | 10.24% |