Agenda Item No:

Report to: Audit Committee

Date of Meeting: **28th June 2010**

Report Title: **Annual Treasury Management Report 2009-10**

Report By: **Head of Financial Services**

Purpose of Report

To provide Audit Committee the opportunity to scrutinise the report before its submission to Cabinet. The proper management of the Council's cash funds is critical to the success of the Council. This report will advise Cabinet of the Treasury Management activities and performance during the last Financial Year.

Recommendation(s)

1. **To note the report and comment on any areas that it wishes to draw to the attention of Cabinet.**

Reasons for Recommendations

To ensure that members are fully aware of the activities undertaken in the year, that Codes of Practice have been complied with and that the Council's strategy has been effective in 2009-10. As delegated by Council the Audit Committee is tasked with scrutinising these activities and to draw to Cabinet's attention any matters it considers important.

1. Introduction and Background

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009 was adopted by this Council on 15th February 2010 and this Council fully complies with its requirements.

The primary requirements of the Code are as follows:

a) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
b) Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
c) Receipt by the Full Council of an annual treasury management strategy report (including the annual investment strategy report for the year ahead, a midyear review report (as a minimum) and an annual review report of the previous year.
d) Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
e) Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body which in this Council is the Audit Committee.

Treasury management in this context is defined as:
"The management of the local authority's investments and 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. "

The purpose of this report is to meet one of the above requirements of the CIPFA Code, namely the annual review report of treasury management activities, for the financial year 2009/10.

2. This Annual Treasury Report Covers

a) the Council's treasury position as at 31 March 2010;
b) the strategy for 2009-10;
c) the economy and interest rates in 2009-10;
d) borrowing rates in 2009-10;
e) the borrowing outturn for 2009-10;
f) debt rescheduling;
g) compliance with treasury limits and Prudential Indicators;
h) investment rates in 2009-10;
i) investment outturn for 2009-10;

3. Treasury Position as at 31 March 2010

The Council's debt and investment position at the beginning and the end of the year was as follows:

TABLE 1	31st March 2009 Principal	Rate/ Return	Life yrs	31st March 2010 Principal	Rate/ Return	Life yrs
Fixed Rate Funding:						
-PWLB Loan1	£7.5m	4.80%	24yrs	£7.5m	4.80%	23yrs
-PWLB Loan2	£2.5m	1.54%	2yrs	£2.5m	1.54%	1yr
-Market	£7.7m	0.50%	Temp.	£2.0m	0.45%	Temp.
	------------			-----------		
	£17.7m	3.37%		£12.0m	4.07%	
Variable Rate Funding:						
-PWLB Loan 3	£2.0m	1.37%	10yrs	£2.0m	0.60%	9yrs
Total Debt	£19.7m	2.34%		£14.0m	3.00%	
Investments:						
-In-House				£3.2m	0.97%	
-With Managers	£16.5m	4.74%		£16.6m	0.96%	
Total Investments	£16.5m	4.74%		£19.8m	0.96%	

4. The Strategy for 2009-10

Bank Rate was expected to continue falling from 2.0% in December 2008 to 0.5% in March 2009 and then stay there throughout 2009/10 before starting to rise in the second quarter of 2010. However, there was a downside risk to this forecast if the recession proved even deeper and longer than expected at that time; this would mean that the first rise in Bank Rate would be delayed.

The effect on interest rates for the UK was therefore expected to be as follows:

Shorter-term interest rates - The "average" City view anticipated that Bank Rate would fall to 0.5% and remain there at the end of 2009 due to the scale of the recession before starting to rise back towards more normal levels in 2010, though it would be 2012 before Bank Rate returned to around 4.5%.

Longer-term interest rates - The view on longer-term fixed interest rates, 50 years, was that they would remain around 3.90 – 3.95% during 2009/10 with the 25 year rate being about 10 – 15 basis points (bps) higher.

The major issue for treasury management in 2009-10 has been the large difference between investment rates and borrowing rates that has emerged during this recession due to: -

a) the unprecedented fall in Bank Rate
b) the disappearance during the year of the margins over more normal investment rates caused by the credit crunch as the Bank of England's quantitative easing operations had the desired effect of easing the supply and cost of credit in the economy during 2009.

A further strong theme has been the major emphasis on mitigating risk by giving heightened preference to security and liquidity at a time when the world banking system was still under stress and pending the issue, later in 2009, of new CIPFA and statutory guidance on investing. This has therefore resulted in more of our investment portfolio being moved into investment instruments with lower rates of return but higher security and liquidity. This has compounded the significant fall in total investment earnings compared to previous years.

Consequently, in order to balance the impact of the loss in investment income, there was a major re-evaluation in 2008/9 of the benefits of new borrowing, whereby significant treasury management savings could be achieved by running down investment balances and/or utilising surplus cash instead of taking new borrowing in order to finance new capital expenditure or to replace debt maturing during the year. Whilst this has continued to provide savings during 2009-10 in terms of debt management costs, the Council needs to be mindful of both interest rate risk and refinancing risk moving forward, in the event that interest rates start to rise. There is a risk that borrowing costs may start to rise throughout 2010-11 due to market concerns regarding government debt levels and the re-emergence of inflationary pressures The Council is continuing to proactively monitor this position in association with its treasury management advisors, Sector.

This Council has also examined the potential for making premature debt repayments in order to reduce investment balances more quickly. However, the level of premiums that would have been incurred and the increase in risk exposure to significantly higher interest rates for new borrowing than current new borrowing in the future, made this option unattractive.

The Council operated both borrowing and investment portfolios and as a consequence was at lower risk from being impacted by a sharp, unexpected rise in short-term variable interest rates.

5. The Economy and Interest Rates

During 2009/10 the Monetary Policy Committee (MPC) was focused on helping the economy to turn around from plunging into the deepest and longest recession the UK economy had experienced for many years.

Despite keeping Bank Rate at an unprecedented historical low of 0.5% all year, the MPC also had to resort to extreme measures in terms of pumping liquidity into the economy through quantitative easing by purchasing £200bn gilts and corporate bonds. This had the effect of boosting prices for gilts and corporate bonds and therefore bringing down yields, so also reducing borrowing costs for both the corporate and public sector.

It was notable that the increase in money supply in the economy generated by this programme brought the credit crunch induced spread between Bank Rate and 3 month LIBID (investment rate that depositors could earn) down from 0.95% at the beginning of the financial year to zero during August 2009.

The dominant focus in 2009/10 was on quarterly GDP growth figures. The recession bottomed out in quarter 1 of 2009. There was then major disappointment that the end of the recession failed to materialise in the third quarter 2009 but the fourth quarter of 2009 did then see economic growth return at +0.4%.

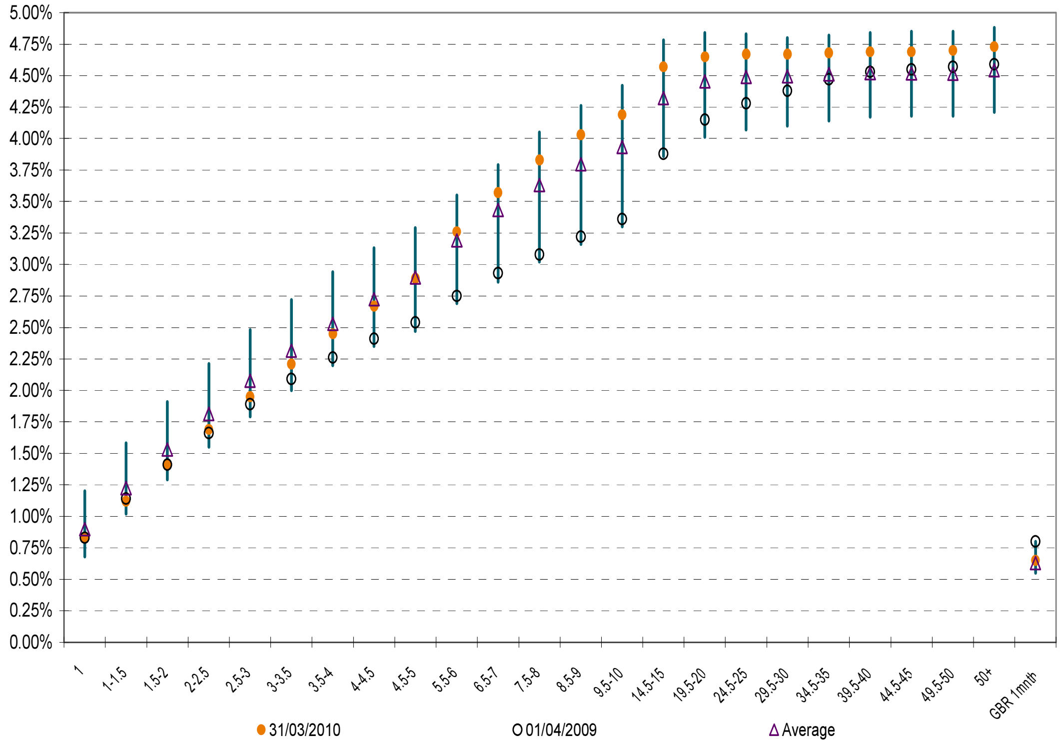
Inflation has not been a major concern of the MPC as it fell back below the 2% target level from June to November. However, it did spike upwards to reach 3.5% on the back of the unwinding of the temporary cut in VAT (back up to 17.5% from 15%) on 1 January 2010. This was not seen as a cause for alarm as this spike was expected to fall out of the inflation index and inflation was forecast by the Bank of England to fall back under target by the end of 2010.

6. Borrowing Rates in 2009-10

PWLB borrowing rates: the graph and table below show, for a selection of maturity periods, the range (high and low points) in rates, the average rates and individual rates at the start and the end of the financial year.

Variations in most PWLB rates this year have been within a fairly limited band compared to previous years with the largest spread being 1.12% in the 10 year in the table below.

PWLB rates 2009-10-



5 year PWLB rate. This started the year at 2.54% and then fell to a low for the year of 2.47% on the following day before then rising sharply to hit a peak of 3.29% in July.

From there it fell till until reaching 2.54% in October and then rose back up to a peak of 3.13% in January. It finished the year at 2.89%.

10 year PWLB rate. This started the year at 3.36% and then fell to a low for the year of 3.30% on the following day before then rising sharply and rose to hit a peak of 4.15% in July. From there it fell until reaching 3.55% in October and then rose back up to a peak of 4.42% in February. It finished the year at 4.19%.

25 year PWLB rate. This started the year at 4.28% and then peaked in the 4.70s during June – August before falling back to a bottom of 4.07% in October. From there it rose again towards the end of the year to return to the 4.70s and peaked at 4.83% in February. It finished the year at 4.67%.

50 year PWLB rate. This started the year at 4.57% and then peaked at 4.85% in June before falling back to a bottom of 4.18% in October. From there it rose again towards the end of the year and peaked at 4.79% in March. It finished the year at 4.70%.

	PWLB BORROWING RATES 2009/10 for 1 to 50 years								
	1	2	3	4	5	10	25	50	1 month variable
1. 4.2009	0.83%	1.41%	1.89%	2.26%	2.54%	3.36%	4.28%	4.57%	0.80%
31.3.2010	0.83%	1.41%	1.95%	2.45%	2.89%	4.19%	4.67%	4.70%	0.65%
HIGH	1.20%	1.91%	2.48%	2.94%	3.29%	4.42%	4.83%	4.85%	0.80%
LOW	0.68%	1.29%	1.79%	2.20%	2.47%	3.30%	4.07%	4.18%	0.55%
spread	0.52%	0.62%	0.69%	0.74%	0.82%	1.12%	0.76%	0.67%	0.25%
average	0.90%	1.53%	2.08%	2.53%	2.90%	3.93%	4.49%	4.51%	0.63%
high date	09/06/2009	12/06/2009	12/06/2009	24/07/2009	28/07/2009	22/02/2010	22/02/2010	02/06/2009	01/04/2009
low date	16/09/2009	09/10/2009	09/10/2009	02/04/2009	02/04/2009	02/04/2009	09/10/2009	09/10/2009	17/07/2009

7. Borrowing Outturn for 2009-10

Treasury Borrowing -
As comparative performance indicators, average PWLB maturity and variable interest rates for Council loans in 2009-10 were:

Loan 1 £7,500,000 maturing in 2033 at 4.80%
Loan 2 £2,500,000 maturing in 2011 at 1.54%
Loan 3 £2,000,000 maturing in 2019 at 0.60% (variable rate loan)

Debt Performance - As highlighted in section 3 above the average debt portfolio interest rate has moved over the course of the year from 2.34% to 3.00% mainly as a result of temporary borrowing. The approach during the year was to fund borrowing from surplus cash. The total amount paid on borrowing in 2010/11 was £414,000

8. Debt Rescheduling

Our treasury management advisors, Sector, started 2009-10 with the expectation that longer-term PWLB rates would be on a rising trend during the year and that shorter term rates would be considerably cheaper. However, moving from long term to short term debt would mean taking on a greater risk exposure to having to re-borrow longer term in later years at considerably higher rates than most of the long term debt currently in the debt portfolio. Short term savings could be achieved by internally financing new capital expenditure and replacing maturing debt by running down existing cash balances which were only earning minimal rates of interest due to the fact that Bank Rate was kept at 0.5% all year.

9. Compliance with Treasury Limits

During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's annual Treasury Strategy Statement. The outturn for the Prudential Indicators is shown in appendix 1.

10. Investment Rates in 2009-10

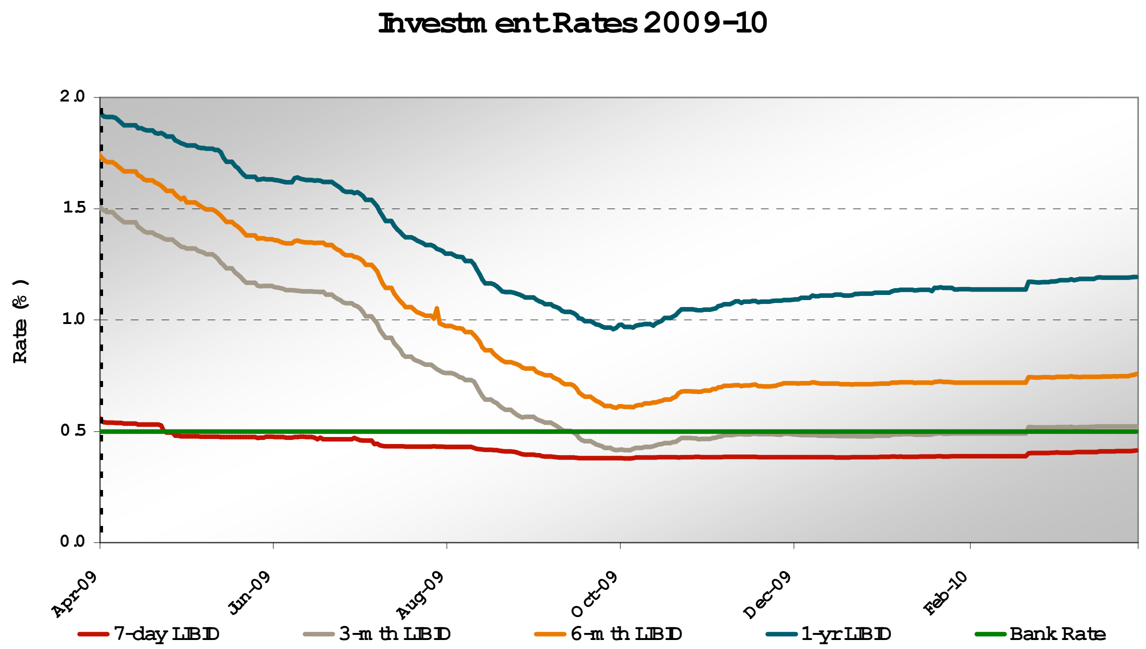
At the start of 2009-10, investment rates were enhanced by a substantial credit crunch induced margin. However, the Bank of England's quantitative easing operations had the desired effect of improving the supply of credit in the economy and so these margins were eliminated by half way through the year. Consequently, investment rates fell markedly during the first half of the year,

Overnight rate: this varied little during the year within a range of 0.38 – 0.49%.

3 month rate: from a high point for the year of 1.50% on 1.4.09, the rate fell gradually to reach a low of 0.42% in September before finishing the year at 0.52%,

12-month rate: this started the year at a credit crunch enhanced rate of 1.85% and fell steadily until reaching 0.85% in September. Since then it has risen to finish the year at 1.15% as the market looked ahead to when the MPC would have to start raising Bank Rate from its then current rate of 0.50%.

	INVESTMENT RATES 2009-10					
	Overnight	7 Day LIBID	1 Month	3 Month	6 Month	1 Year
01-Apr-09	0.49%	0.55%	0.89%	1.50%	1.73%	1.93%
31-Mar-10	0.41%	0.41%	0.42%	0.52%	0.76%	1.19%
High	0.49%	0.55%	0.89%	1.50%	1.73%	1.93%
Low	0.38%	0.38%	0.38%	0.42%	0.61%	0.96%
Average	0.40%	0.42%	0.47%	0.73%	0.94%	1.29%
Spread	0.12%	0.17%	0.51%	1.09%	1.13%	0.97%
high date	01/04/2009	01/04/2009	01/04/2009	01/04/2009	01/04/2009	01/04/2009
low date	09/09/2009	02/10/2009	18/09/2009	29/09/2009	29/09/2009	28/09/2009



11. Investment Outturn for 2009-10

Internally Managed Investments - the Council manages some investments in-house and invests with the institutions listed in the Council's approved lending list. The Council invests for a range of periods from overnight to 364 days, dependent on the Council's cash flows, its interest rate view, the interest rates on offer and durational limits set out in the approved investment strategy. The total investment income in 2009/10 amounted to £230,000

During the year all investments were made in full compliance with this Council's treasury management policies and practices.

12. Investment Strategy

Pending the issuance of revised CIPFA and statutory investment guidance expected towards the end of the year, and in the light of continuing stresses on the world banking system, enhanced priority was given to security and liquidity in order to reduce counterparty risk to the maximum possible extent.

In order to counter the downturn in investment rates part of the investment portfolio was held in liquidity accounts with main UK banks. These accounts offered both instant access and rates which were often double those available in the money markets through brokers for overnight money and higher than for most periods up to six months.

Prior to the start of 2009-10, the expected investment strategy for in-house managed funds was that short term rates would rise during the year. Investments were, accordingly, kept short, with a view to enabling returns to be compounded more frequently.

Externally Managed Investments - the Council has investments managed externally by Aviva. The fund management agreement between the Council and the Fund Manager defines the limits for maximum weighting in gilts/bonds and maximum duration of the fund. Counterparty criteria and exposure limits are also pre-defined therein.

Investment Performance for 2009-10 - Detailed below is the result of the investment strategy undertaken by the Council.

TABLE 2	Average Investment	Rate of Return (gross of fees)	Rate of Return (net of fees)	Benchmark Return
Internally Managed	£1.40m	0.97%	N/A	0.42%
Externally Managed	£16.55m	1.09%	0.96%	0.42%

No institutions in which investments were made during 2009/10 had any difficulty in repaying investments and interest in full during the year.

12. Financial Implications

The past year has been one of few opportunities to reschedule debt and with historically low interest rates available to investors. There are no areas of concern that I need to bring to Members attention.

Appendix 1: Prudential Indicators

TABLE 3: PRUDENTIAL INDICATORS	2008/09	2009/10	2009/10
Extract from budget and rent setting report	actual	original	actual
	£'000	£'000	£'000
Capital Expenditure	£6,820	£7,164	£6,449
Ratio of financing costs to net revenue stream	1.3%	-0.7%	-0.7%
Net borrowing requirement			
in year borrowing requirement	£2,264	£901	£1,016
Capital Financing Requirement as at 31 March	£13,165	£13,735	£13,849
Annual change in Cap. Financing Requirement	£2,074	£570	£684
Incremental impact of capital investment decisions	£ p	£ p	£ p
Increase in council tax (band D) per annum	£1.92	£0.82	£0.93

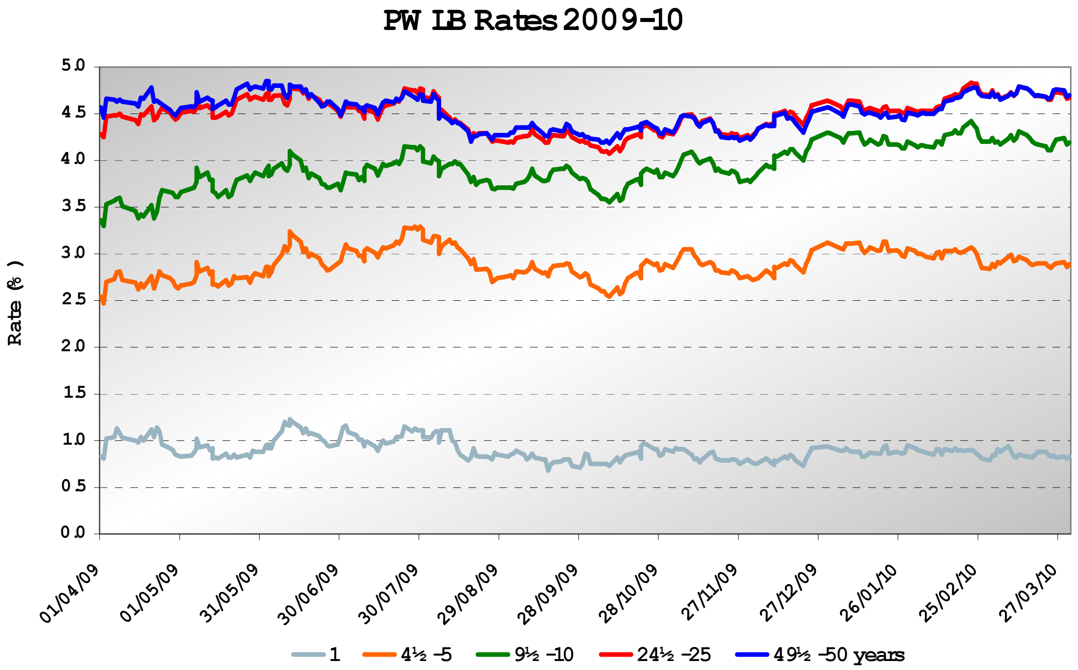
TABLE 4: TREASURY MANAGEMENT INDICATORS	2008/09	2009/10	2009/10
	actual	original	actual
	£'000	£'000	£'000
Authorised Limit for external debt -			
borrowing	£45,000	£20,000	£20,000
other long term liabilities	£0	£0	£0
TOTAL	£45,000	£20,000	£20,000
Operational Boundary for external debt -			
borrowing	£30,000	£20,000	£20,000
other long term liabilities	£0	£0	£0
TOTAL	£30,000	£20,000	£20,000
Actual external debt	£12,000	£12,000	£12,000
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / investments	100 %	100 %	100 %
Upper limit for variable rate exposure			
Net principal re variable rate borrowing / investments	100 %	100 %	100 %
Upper limit for total principal sums invested for over 364 days	£0	£0	£0

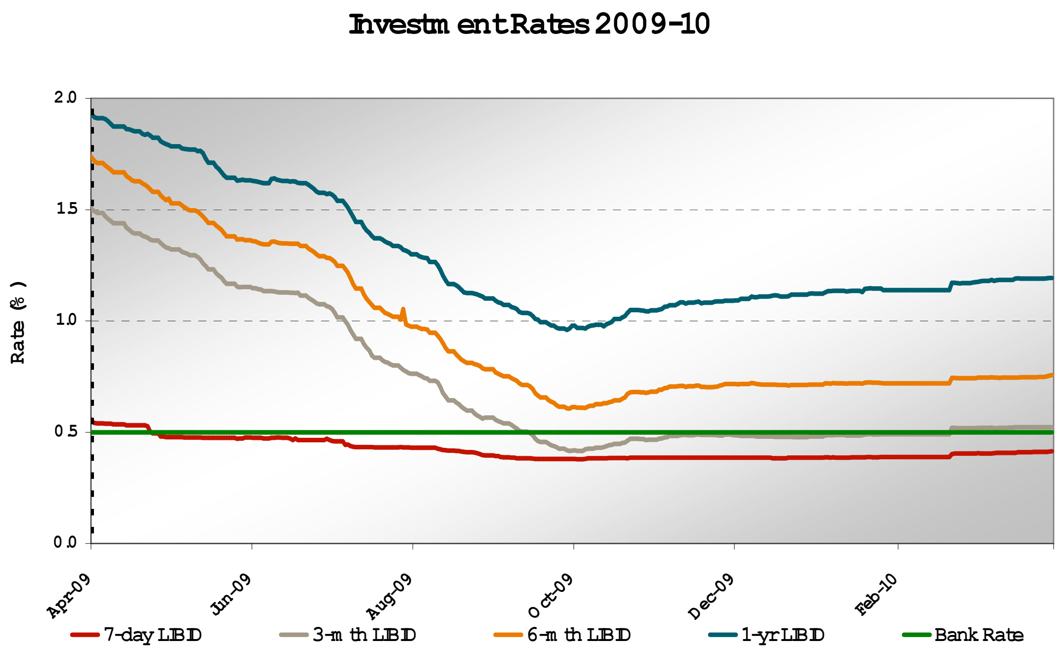
TABLE 5: Maturity structure of fixed rate borrowing during 2010/11	upper limit	lower limit
under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

Appendix 2: Central Bank Rate Movements

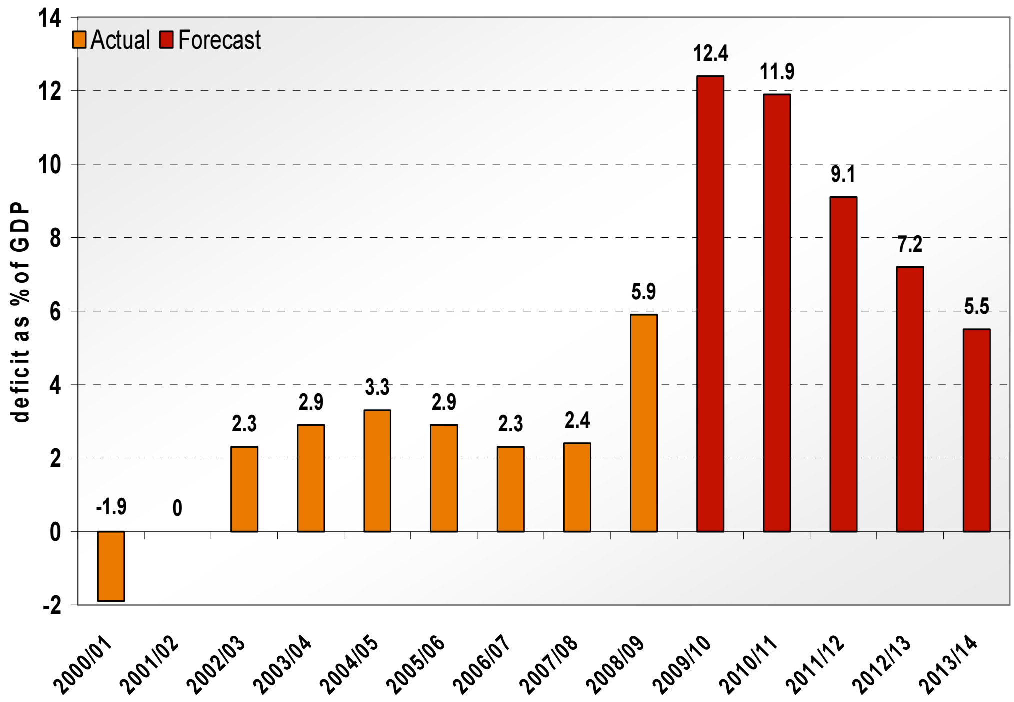
	UK	UK	UK	US	EU	UK	US	ECB
	MPC	MPC Minutes	Inflation Report	FOMC	ECB	Bank Rate	Fed. Rate	Refi Rate
2008								
Jan	-	-		22		5.50%	3.50%	4.00%
Jan	9-10	23		29-30	10	5.50%	3.00%	4.00%
Feb	6-7	20	13	21 (mins)	7	5.25%	3.00%	4.00%
Mar	5-6	19		18	6	5.25%	2.25%	4.00%
Apr	9-10	23		29-30	10	5.00%	2.00%	4.00%
May	7-8	21	14		8	5.00%	2.00%	4.00%
Jun	4-5	18		24-25	5	5.00%	2.00%	4.00%
Jul	9-10	23			3	5.00%	2.00%	4.25%
Aug	6-7	20	13	5	7	5.00%	2.00%	4.25%
Sep	3-4	17		16	4	5.00%	2.00%	4.25%
Oct	8-9	22		28-29	2	4.50%	1.50%	3.75%
Nov	5-6	19	12		6	3.00%	1.00%	3.25%
Dec	3-4	17		16	4	2.00%	0-0.25%	2.50%
2009								
Jan	7-8	21		27-28 (7 mins)	15	1.50%	0-0.25%	2.00%
Feb	4-5	18	11		5	1.00%	0-0.25%	2.00%
Mar	4-5	18		17	5	0.50%	0-0.25%	1.50%
Apr	8-9	22		28-29	2	0.50%	0-0.25%	1.25%
May	6-7	20	13		7	0.50%	0-0.25%	1.00%
Jun	3-4	17		23-24	4	0.50%	0-0.25%	1.00%
Jul	8-9	22			2	0.50%	0-0.25%	1.00%
Aug	5-6	19	12	11	6	0.50%	0-0.25%	1.00%
Sep	9-10	23		22	3	0.50%	0-0.25%	1.00%
Oct	7-8	21			8	0.50%	0-0.25%	1.00%
Nov	4-5	18	11	3-4	5	0.50%	0-0.25%	1.00%
Dec	9-10	23		15	3	0.50%	0-0.25%	1.00%
2010								
Jan	6-7	20		27	14	0.50%	0-0.25%	1.00%
Feb	3-4	17	10		4	0.50%	0-0.25%	1.00%
Mar	3-4	17		16	4	0.50%	0-0.25%	1.00%

Appendix 3: Graphs

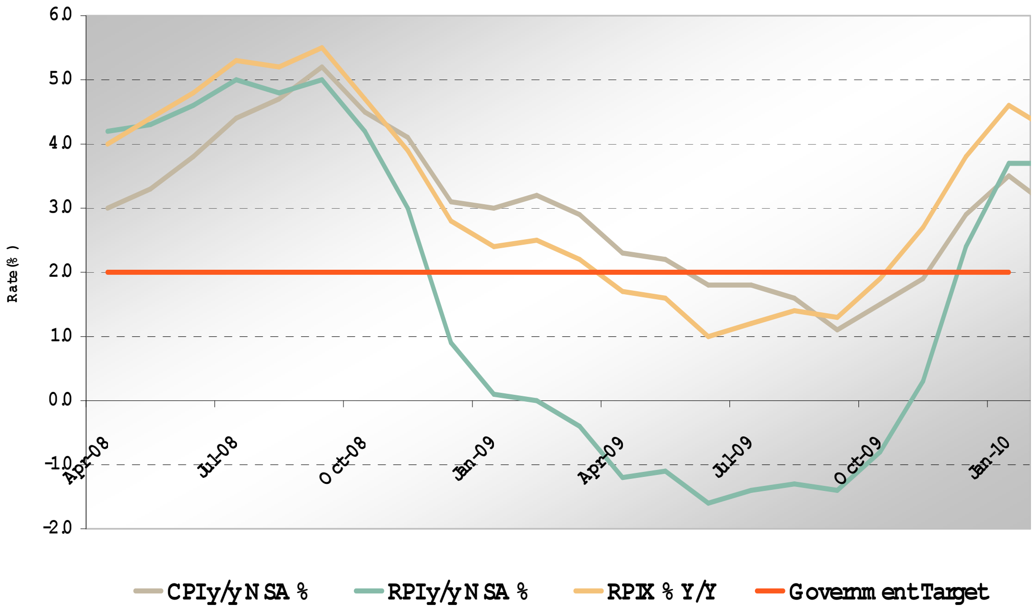




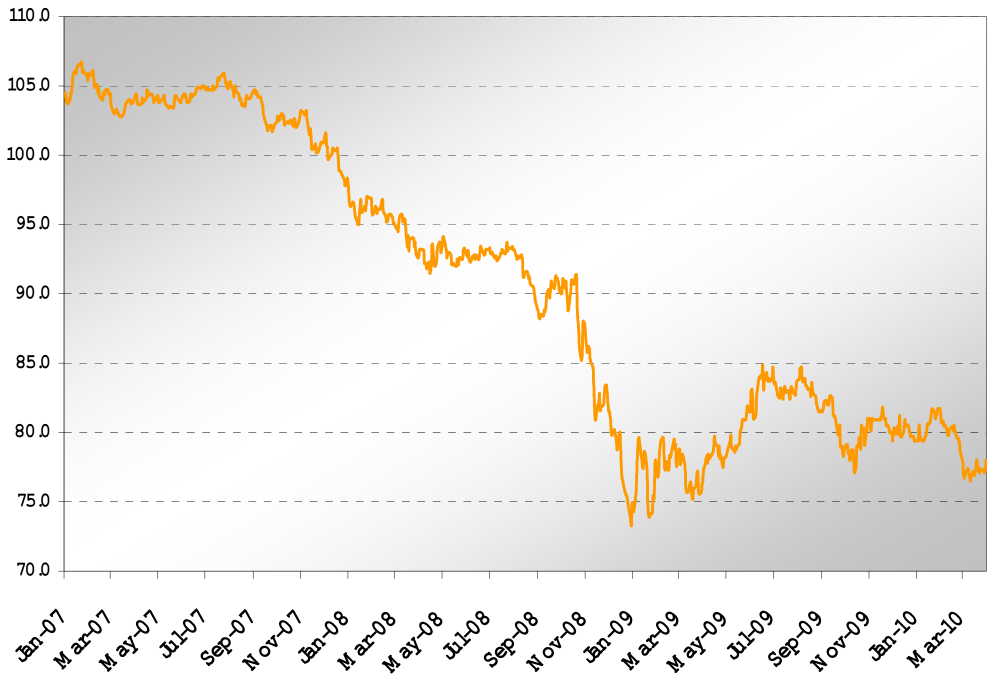
Public Sector Net Borrowing Requirement per March 2010 Budget



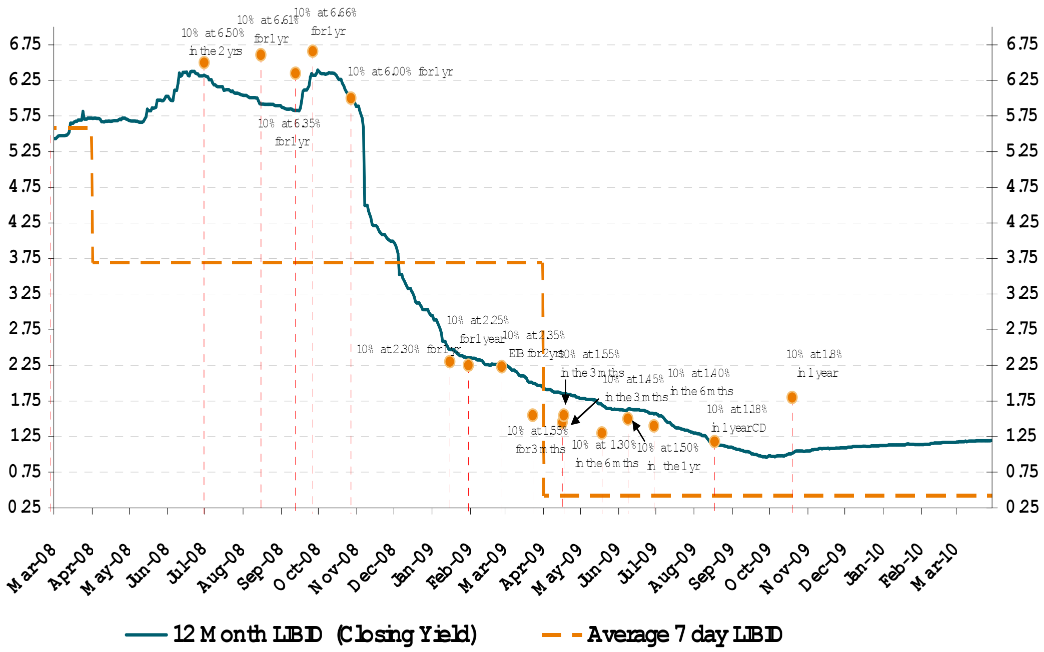
UK Inflation April 2008-March 2010



Exchange Rate Indicator Jan 2007-March 2010



Sector Investment Advice March 2008-March 2010



Wards Affected

Ashdown, Baird, Braybrooke, Castle, Central St. Leonards, Conquest, Gensing, Hollington, Maze Hill, Old Hastings, Ore, Silverhill, St. Helens, Tressell, West St. Leonards, Wishing Tree

Area(s) Affected

Central Hastings, East Hastings, North St. Leonards, South St. Leonards

Policy Implications

Please identify if this report contains any implications for the following:

Equalities and Community Cohesiveness	No
Crime and Fear of Crime (Section 17)	No
Risk Management	Yes
Environmental Issues	No
Economic/Financial Implications	Yes
Human Rights Act	No
Organisational Consequences	No

Background Information

none

Officer to Contact

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