

Report to: **Cabinet**

Date: **28 April 2009**

By: **Deputy Chief Executive & Director of Corporate Resources**

Title of report: **Treasury Management – Stewardship Report 2008/09 and amendment to 2009/10 Strategy**

Purpose of report: **To present a review of the County Council's performance on treasury management for the year 2008/09 and recommend a change to the current strategy.**

RECOMMENDATION

The Cabinet is recommended to note the treasury management performance in 2008/09 and recommend the County Council to approve the amendment to the current strategy as set out in paragraph 3 below.

1. Financial Appraisal

The annual stewardship report reviews the Council's treasury management performance and is required by the Code of Practice for Treasury Management. The proposed amendment to the current policy will give more flexibility within acceptable risk limits.

2. Supporting Information

2.1 Introduction

The County Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance. The County Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Sector and operates its treasury management service in compliance with this Code. These require that the prime objective of the treasury management activity is the effective management of risk, and that its borrowing activities are undertaken in a prudent, affordable and sustainable basis. The Code requires the regular reporting of treasury management activities to:

- Forecast the likely activity for the forthcoming year (in the Annual Treasury Strategy Report); and
- Review actual activity for the proceeding year (this report).

This report sets out:

- A summary of the original strategy agreed for 2008/09 and the economic factors affecting this strategy (Appendix A) and the current strategy (Appendix B);
- The treasury management activity during the year (Appendix C);
- The Prudential Indicators, which relate to the Treasury function and compliance with limits (Appendix D).

2.2 The economic conditions compared to our original strategy for 2008/09

The original strategy and the economic conditions prevailing in 2008/09 are set out in Appendix A which is attached to this report. Overall the advice received from Butlers, our advisors, early in 2008 was that interest rates would be close to or slightly higher than their existing levels in 2007/08 and would fall slightly over the following three years (2008/09, 2009/10 and 2010/11). Clearly, due to the credit crunch and the recession, this advice turned out not to be the case.

2.3 The treasury activity during the year on short term investments and borrowing;

Revisions to the Treasury Management Strategy

The strategy for 2008/09, agreed in January 2008, included two changes to the investment arrangements to take account of the increased risk. Due to the worsening situation in the financial markets, further changes were put into place during the year (July and November 2008 and February 2009).

As the money markets had been particularly volatile it was necessary to review and adjust the investment tactics on a daily, sometimes hourly basis. The policy agreed in February 2009 and still in place is set out in full in Appendix B. Changes to that policy are recommended in paragraph 3 below.

Short term lending

The total amount received in short term interest for 2008/09 was £11.89m at an average rate of 4.16%. This was above the average of base rates in the same period (3.62%).

Long term borrowing

Details of our long term borrowing are included in Appendix B of the report. The important points are:

- No new borrowing was undertaken with PWLB during 2008/09. The County Council borrowed £6.45m from Barclays during 2008/09 at an interest rate of 4.25% pa (lower than PWLB rates), with a repayment due date of 10th October 2058.
- In February it was agreed to use "internal borrowing" to finance new capital investment and it was also agreed to repay some £13m of existing PWLB loans – this has taken place and will give total savings of £458,820 (see Appendix C).

As a result of these changes (excluding premium on repayment of PWLB loans), the average interest rate of all debt at 31 March 2009 (£264m) has fallen to 5.17% compared to 5.45% at 31 March 2008.

Short term borrowing

No Borrowing was undertaken on a short-term basis during 2008/09 to cover temporary overdraft situations.

2.4 Prudential Indicators which relate to the Treasury function and compliance with limits

The County Council is required by the Prudential Code to report the actual prudential indicators after the end of each year. There are five indicators which relate to treasury management and they are set out in Appendix D. The actual position for the County Council for 2008/09 is that performance against all borrowing and prudential indicators is within the limits set in the Strategy for the year.

3. Amendment to current strategy

Under the current strategy all lending other than to the Government Debt Management Office must be on a daily basis. It is now felt that the risk of lending for longer periods (up to 3 months) to the existing limited range of high quality banks eligible for the Government Credit Guarantee Scheme and to money market funds is acceptable and will generate higher returns. It is also recommended that the maximum which can be lent to Nat West (the Council's bankers) be increased from £35m to £65m. Cabinet is recommended to approve this increased flexibility and recommend the County Council to adopt this amendment to the strategy.

4. Conclusion and reason for recommendation

This report updates the Cabinet and fulfils the requirement to submit an annual report in the form prescribed in the Treasury Management Code of Practice. The Cabinet will wish to note that the proactive approach adopted means that, in line with the strategy, the average rate of interest payable on borrowing has fallen from 5.45% in 2007/08 to 5.17% in 2008/09. Short term lending has achieved returns better than base rate at minimum risk. Exposure to future risk continues to be minimised through proactive and constant review of the treasury management policy.

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BACKGROUND DOCUMENTS

Cabinet 29 January 2009 Borrowing Limit and Treasury Management Strategy for 2008/09
Cabinet 25 November 2008 Further Revisions to the Treasury Management Strategy for 2008/09
CIPFA Treasury Man't in the Public Services- Code of practice and cross sectional guidance notes
Local Government Act 2003
Local Government Investments –Guidance from the Office of the Deputy Prime Minister

Appendix A

A summary of the strategy agreed for 2008/09 and the economic factors affecting this strategy

1. Original strategy for 2008/09

1.1 The Cabinet at its meeting on 29 January 2008 agreed its treasury management strategy for 2008/09, taking into account the economic scene including forecast levels of interest rates. At the same time, the Treasury Management Policy Statement was agreed for 2008/09.

East Sussex County Council defined its treasury management activities as:

“The management of the organisation’s cash flows, its banking, money market and capital market transactions (other than those of the Pension Fund) the effective management of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.”

The County Council regards the successful identification, monitoring and management of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.

This authority acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

1.2 The strategy and plan was to continue to aim to borrow long term to finance the capital programme at the lowest rate available during the year and for short term borrowing and lending to be at the best rates available consistent with low risk. Opportunities were to be taken to restructure long term debt if and when they arose.

1.3 The main points of the advice received in January 2008 on interest rates for 2008/09 were:

- short term rates, currently at 5.5% (January 2008), will reduce to 5% in the early part of 2008/09 and reduce again in September to 4.75% and remain at this level for the rest of the year.
- long term (45-50 year) interest rates currently around 4.5% will be slightly higher (4.7%) in 2008/09. The estimated rate is, therefore, 4.7%.
- The advice received for the following years was that short term rates will be an average of 4.8% in 2009/10 and increase to 5% in 2010/11 and 5.2% in 2011/12.
- The average long term interest rates will be slightly higher at 4.8% in 2009/10 and will increase slightly by 0.2% to 5% in 2010/11 and continue to rise to 5.3% in 2011/12.
- The advice is subject to changes in the world and political climate which could alter the interest rates significantly.

Overall the advice was that short term interest rates would reduce in 2008/09 and stay at this level in 2009/10 and then increase in 2010/11 and 2011/12. Long term rates would be slightly higher in 2009/10 and will continue to rise in 2010/11 and 2011/12.

2. The economy in 2008/09 – Commentary from Butlers (April 2009)

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

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

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

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

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

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

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

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

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

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

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

Appendix B

Current Treasury Management Policy for 2009/10 – approved by County Council February 2009

1.1 In the current economic climate it is essential that a very prudent approach is maintained. This will be primarily achieved through investing with DMADF and on an overnight basis with selected banks and funds which meet the Council's rating criteria.

1.2 It is also important to recognise that movements within the money markets can happen with no notice and the Deputy Chief Executive and Director of Corporate Resources may have to amend this strategy in order to safeguard Council funds. As in the past any such actions will be reported to the next Cabinet meeting. An example of that is exercising a judgement to place more weight on UK Government's moral guarantee to high street banks if there are marginal movements in credit rating for the same high street banks.

1.3 It is not expected that any new external borrowing will be undertaken in the next 15 months however the limits set out would allow such borrowing. External borrowing will only take place if the rates available are so low that the long term benefits will significantly exceed the short term cost.

1.4 As well as using internal borrowing to finance new capital investment it is further proposed to repay some £13m of existing PWLB loans. Further cost effective repayment opportunities will be taken if and when they emerge.

1.5 The different elements of the total cash balances to be invested will be dealt with as follows:

- 1) Fire Authority – invested in line with their own specific policy and in the first instance assumed to mirror County Council policy at 3 below (estimated average £11m)
 - 2) Interest on specific Council reserves – invested solely in DAMDF (estimated average £85m)
 - 3) Balance of Council funds (estimated average £180m)
- Up to £120m maximum deposited on an overnight basis only with any of the following to the individual limits shown:

Bank / Fund	Proposed Maximum Investment
Barclays	£35m
Lloyds HBOS	£35m
Nat West (call account maximum)	£35m
Abbey	£35m
Treasury backed money market funds (AAA rated)	£35m
Money Market Funds (AAA rated)	£35m

Only banks which are eligible for the Government's Credit Guarantee Scheme and meet the following minimum rating criteria to be used (with the exception of Nat West, the Council's existing bankers, which currently fall below this criteria on the Standard and Poors rating only – but this will be kept under close review).

Ratings Agency	Long Term	Short Term
Fitch	AA-	F1+
Moody	AA3	P-1
Standards and Poors	AA-	A-1+

- The balance in excess of £120m to be deposited with DMADF.

Appendix C

The treasury activity during the year on borrowing and short-term investments

1. Short term lending interest rates

As mentioned in Appendix A, base interest rates started at 5.25%. During April, the rate reduced to 5.00% and remained at that level until October, when it was reduced to 4.50%. Since then, the rate has dramatically reduced to 3.00% in November, 2.00% in December, 1.50% in January 2009, 1.00% in February, and finally 0.50% in March.

2. Long term borrowing

2.1 The County Council has had a strategy to borrow to support the Capital Programme and it lends out other cash (rather than using internal borrowing). Historically this meant that the interest rate earned on cash balances was higher than the interest rate paid on loans from the Public Works Loans Board (PWLB). In the current financial climate, this interest rate differential has been removed. No new PWLB borrowing has taken place since January 2008 and is unlikely in the current climate unless long term PWLB rates reach a very low level (where the long term benefit would exceed the short term costs).

2.2 The County Council borrowed £6.45m from Barclays LOBO during 2008/09 at an interest rate of 4.25% pa, with a repayment due date of 10th October 2058.

2.3 Indeed, as well as using the existing cash balances to finance capital spending (rather than new borrowing) it was also considered prudent to repay early some £13m of relatively expensive PWLB loans which were due to mature in the next 5 years. This reduced the overall counterparty risk on lending, and gave some savings (even after paying the PWLB premium for early redemption).

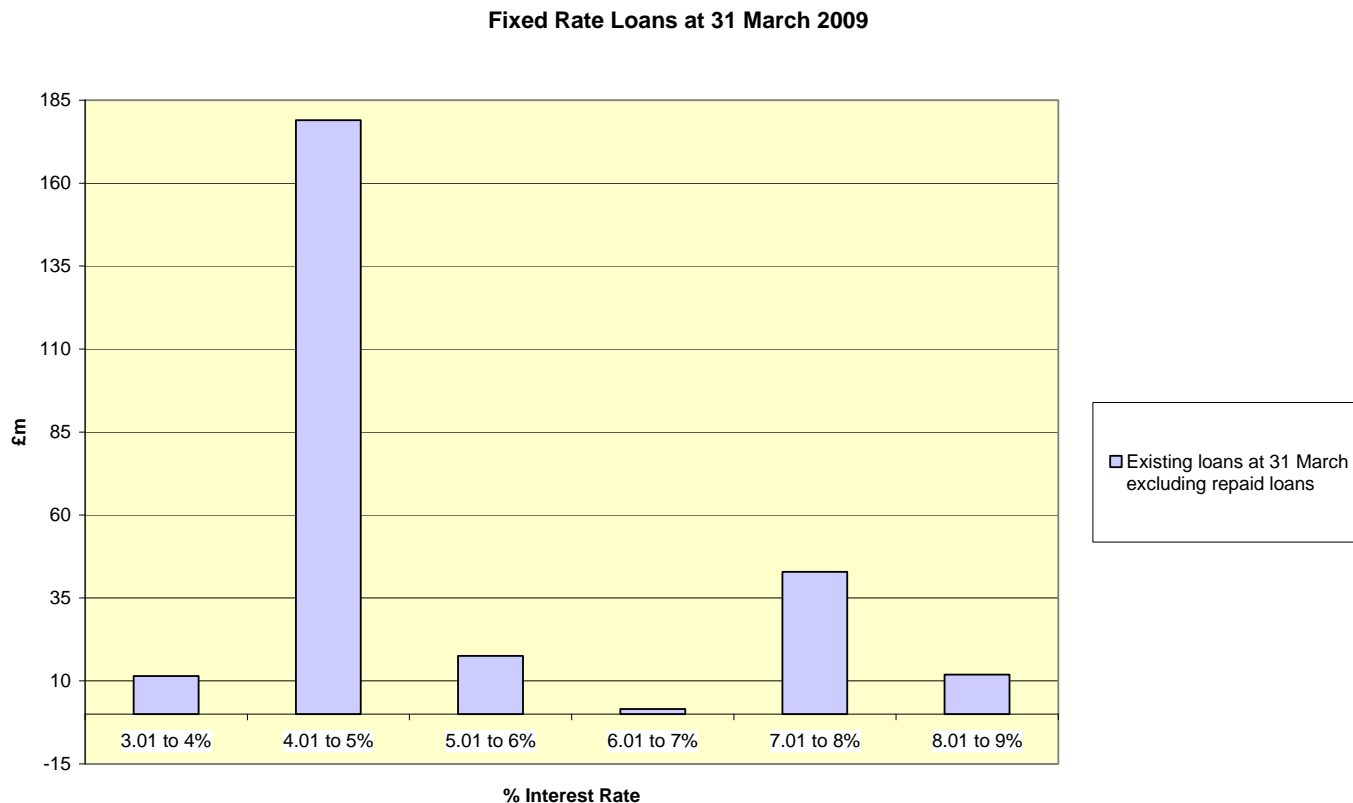
2.4 A premium arising on the early repayment of loans of £2.5m has to be paid, but overall, the repayments of loans will result in a total savings of £458,820.

2.5 The following PWLB loans were repaid during 2008/09

Principal £	Coupon	Maturity Date	Life of Current Loan	Premium £	Total Savings £
1,425,135.08	7.875%	31-Mar-11	2.09	192,725.04	13,093
988,465.89	8.125%	30-Jun-11	2.34	155,217.95	9,966
329,488.63	8.125%	30-Jun-11	2.34	51,739.32	3,322
658,977.26	7.375%	30-Sep-11	2.59	97,680.90	11,534
591,612.65	7.750%	30-Sep-11	2.59	93,312.07	10,361
396,853.24	7.750%	30-Sep-11	2.59	62,593.65	6,950
1,647,443.15	7.875%	31-Mar-12	3.09	304,015.06	45,615
658,977.26	8.500%	30-Jun-12	3.34	144,560.58	19,711
1,317,954.52	8.000%	30-Sep-12	3.59	277,318.31	52,518
658,977.26	7.875%	31-Dec-12	3.84	144,995.45	28,038
1,317,954.52	8.125%	31-Mar-13	4.09	310,347.64	71,017
1,317,954.52	8.000%	30-Sep-13	4.59	328,822.85	90,881
1,317,954.52	7.875%	31-Dec-13	4.84	338,382.84	95,814
12,627,748.50	7.95%		3.38	2,501,711.66	458,820

2.6 The “average” rate of all our debt at 31 March 2009 was 5.17% compared to 5.45% at 31 March 2008. The total outstanding loan debt at 31 March 2009 is £264m.

The range of interest rates payable in all of the loans is illustrated in the graph below:



3. Short term borrowing

3.1 No borrowing was undertaken on a short-term basis during 2008/09 to cover temporary overdraft situations.

Appendix D

Prudential Indicators which relate to the Treasury function and compliance with limits

1.1 The County Council is required by the Prudential Code to report the actual prudential indicators after the end of each year. There are seven indicators which relate to treasury management and they are set on an annual basis and monitored, they comprise:-

- Operational and authorised borrowing limits
- Interest rate exposure
- Interest rate on long term borrowing
- Maturity structure of debt
- Maturity structure of investments
- Compliance with the Treasury Management Code of Practice
- Interest on investments

None of the limits has been exceeded in 2008/09.

1.2 Operational and authorised borrowing limits.

The tables below sets out the estimate and projected capital financing requirement and long-term borrowing in 2008/09

	CAPITAL FINANCING REQUIREMENT	2008/09	2008/09
		Estimate £m	Projected Actual £m
	Capital financing requirement at 1 April 2008	274	274
ADD	Borrowing to support capital programme	23	23
LESS	Provision for repayments of debt	-11	-11
		-----	-----
	Capital financing requirement at 31 March 2009	286	286
ADD	Net borrowing for next year	20	

	Operational Limit	306	
ADD	Short term borrowing	20	Nil

	Authorised Limit	326	

	ACTUAL BORROWING	2008/09
		Actual £m
	Long term borrowing at 1 April 2008	271.5
ADD	Borrowing to support capital programme	6
LESS	Repayments of PWLB debt	-13
	Long term borrowing at 31 March 2009	264.5

The Operational Limit for borrowing was based on the same estimates as the authorised limit. It reflected directly the authorised borrowing limit estimate without the additional amount for short term borrowing included to allow, for example, for unusual cash movements. The Operational Limit represents a key management tool for in year monitoring and long term borrowing control.

The Authorised Limit was consistent with the County Council's current commitments, existing plans and the proposals for capital expenditure and financing, and with its approved treasury management policy statement and practices. It was based on the estimate of most likely, prudent but not worst case scenario, with in addition sufficient headroom (short term borrowing) over and above this to allow for day to day operational management, for example unusual cash movements or late receipt of income. Risk analysis and risk management strategies were taken into account as were plans for capital expenditure, estimates of the capital financing requirement and estimates of cash flow requirements for all purposes.

The Authorised Limit is the "Affordable Borrowing Limit" required by S3 of the Local Government Act 2003 and must not be breached. The Long Term borrowing at 31 March 2009 of £264m is under the Operational Limit and Authorised Limit set for 2008/09. The Operational Limit and Authorised Limit were not exceeded during the year.

1.3 Interest rate exposure

The County Council continued the practice of seeking to secure competitive fixed interest rate exposure for 2008/09. To provide flexibility however it set limits on our variable rate exposure in case that became a more effective approach. There are figures for both borrowing and lending and a combined borrowing and lending table.

Borrowing 2008/09 Estimate

Fixed Rate Exposure	
Upper Limit	100%
Lower Limit	92%

Variable Rate Exposure	
Upper Limit	8%
Lower Limit	0%

Lending

Fixed Rate Exposure	
Upper Limit	100%
Lower Limit	0%

Variable Rate Exposure	
Upper Limit	100%
Lower Limit	0%

Borrowing and Lending combined

Fixed Rate Exposure	
Upper Limit	100%
Lower Limit	46%

Variable Rate Exposure	
Upper Limit	100%
Lower Limit	0%

In 2008/09, all borrowing and lending was at fixed rates (the County Council has no variable rate loans at all) and the flexibility in the interest rate exposure was not required.

1.4 Interest rate on long term borrowing

The rate of interest taken on new long term borrowing has been monitored and the following targets set.

- Rate taken on borrowing is within 0.25% of lowest point for set loan period (i.e. 45-50 years) during the year
- Rate taken is within lowest eighth of rates available for set loan period (i.e. 45-50 years) during the year

Date Taken	Amount	Rate	Term years
10/10/08	£6.45m	4.25%	50.0

In 2008/09, the loan taken was a market loan and not with PWLB. The rates offered by the PWLB reduced substantially in the second half of the year. No proper comparison can be made with other market loans as banks withdrew offering new loans in the third and fourth quarter of 2008/09.

1.5 Maturity structure of debt

The Council has set upper and lower limits for the maturity structure of its borrowings as follows.

	<u>Lower limit</u>	<u>Upper limit</u>
Under 12 months	0%	25%
12 months and within 24 months	0%	40%
24 months and within 5 years	0%	60%
5 years and within 10 years	0%	80%
10 years and above	50%	100%

The County Council has not exceeded the limits set in 2008/09.

	<u>Actual at 31.3.2009</u>
Under 12 months	0%
12 months and within 24 months	0%
24 months and within 5 years	4%
5 years and within 10 years	7%
10 years and above	89%

In addition, two targets have monitored the maturity structure of our debt. Not more than £20m of debt should mature in any financial year and not more than 15% to mature in any two consecutive financial years. These targets are both in line at 31st March 2009.

New borrowing was undertaken giving due consideration to the debt maturity profile, ensuring that an acceptable amount of debt is due to mature in any one financial year. This helps to minimise the authority's exposure to the risk of having to replace a large amount of debt in any one year or period when interest rates may be unfavourable. The bar chart in the attached Annex shows the maturity profile.

1.6 Maturity structure of investments

From 1 April 2004, the Investment Guidance issued by the Officer of Deputy Prime Minister, allowed local authorities the freedom to invest for more than for one year. The County Council has taken advantage of this freedom. The limits set for 2008/09 were:

- Investments of over one year and up to five years
- Only institutions of the highest quality
- The list of banks will continue to be regularly monitored to ensure that their financial strength and low risk has been maintained.
- All investments over one year to be classified as Non-Specified Investments
- A limit of £65m for 2008/09 that can be held within this category at any time.
- Any investments made of over one year must match the County Council's policies, for example, investment of the Waste reserve where the balances can be lent out for a known period before being required.

Year invested	Opening balance	Movement in amount invested over 364 days and up to 5 years	Closing balance
Actual 2008/09	£m 50	£m -30	£m 20

The limits set have not been exceeded and £20m of Non-Specified Investments are held within our overall portfolio of investments. No new long term investments (over 364 days) have been taken in 2008/09.

1.7 Compliance with the Treasury Management Code of Practice

East Sussex County Council has adopted the CIPFA *Code of Practice for Treasury Management in the Public Services*.

1.8 Interest on investments

The table below sets out the average monthly rate received on our investments and compares it to the Bank of England Base rate plus 0.10%. From 1 April 2009, investment will be compared to the Bank of England Base Rate, to reflect both the interest rates available in the market and limitation in the use of counterparties.

Month	Av monthly rate	Margin over Base
April	5.56%	0.48%
May	5.48%	0.48%
June	5.43%	0.43%
July	5.55%	0.55%
August	5.55%	0.55%
September	5.49%	0.49%
October	4.99%	0.22%
November	3.75%	0.50%
December	2.56%	0.46%
January	1.88%	0.28%
February	1.67%	0.60%
March	1.42%	0.86%
Average in 2008//09	4.16%	0.54%

The average monthly interest rate received in 2008/09 was 0.54% above the Bank of England Base Rate, which beat the target of 0.10% above the Base Rate.

Annex

Debt Maturity Profile at 31 March 2009

