Inverclyde council

AGENDA ITEM NO. 3

Report To:	**Policy & Resources Committee**	**Date:**	**17 August 2010**
Report By:	**Chief Financial Officer**	**Report No:**	**FIN/42/10/AP/KJ**
Contact Officer:	**Alan Puckrin**	**Contact No:**	**01475 712223**

Subject: **TREASURY MANAGEMENT – ANNUAL REPORT 2009/10**

1.0 PURPOSE

1.1 The purpose of this report is to advise members of the operation of the treasury function and its activities for 2009/10 as required under the terms of Treasury Management Practice 6 (“TMP6”) on “Reporting Requirements and Management Information Arrangements”.

2.0 SUMMARY

2.1 As at 31st March 2010 the Council had debt of £183,705,315 and investments of £44,902,743.

2.2 The average rate of return achieved on investments during 2009/10 was 2.37% which exceeds the benchmark return rate for the year of 0.42% by 1.95%. The Council’s Loans Fund Pool rate was 3.81% which is the lowest ever achieved by the Council and is expected to be one of the lowest in Scotland.

2.3 During 2009/10 the Council undertook debt restructuring (in quarter 1) and operated within the treasury limits and Prudential Indicators set out in the Council’s Treasury Policy Statement, annual Treasury Strategy Statement, and the Treasury Management Practices apart from the following: a short-term breach as reported to Committee in September 2009 and the Council exceeded its limit for the maximum proportion of debt repayable in one year (as reported to Committee) but in respect of 2077/78.

3.0 RECOMMENDATIONS

3.1 It is recommended that the Committee notes the contents of the annual report on Treasury Management for 2009/10 and the ongoing work to ensure the delivery of financial benefits for the Council.

3.2 It is also recommended that, in line with new Scottish Government regulations, the Annual Report be remitted to the Council for consideration.

Alan Puckrin
Chief Financial Officer

4.0 BACKGROUND

4.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management 2001 has been adopted by this Council and the Council fully complies with its requirements. The primary requirements of the Code are:

1. The creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. The creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. The receipt by the Council of an annual strategy report for the year ahead and an annual review report of the previous year. A mid-year review is required from 2010/11 onwards.
4. The 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.
5. The 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 Policy & Resources Committee.

Annual Report for 2009/10

4.2 Treasury Management in this context is defined as: "The management of the local authority's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

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.

4.3 This annual treasury report covers:

- the Council's treasury position as at 31st March 2010;
- performance measurement;
- the strategy for 2009/10;
- the economy and interest rates in 2009/10;
- the borrowing outturn for 2009/10;
- debt rescheduling;
- compliance with treasury limits and Prudential Indicators;
- investment strategy and outturn for 2009/10
- other issues.

Treasury Management is a complex area with its own terminology and acronyms. In order to aid the Committee's understanding a Glossary of Terms is attached as Appendix 1.

4.4 Treasury Position As At 31st March 2010

The Council's debt and investment position was as follows:

	31st March 2010		31st March 2009	
	Principal	Rate	Principal	Rate
	£000		£000	
Fixed Rate Funding:				
- PWLB	80,779		75,782	
- Market *	51,000		61,000	
	131,779	4.228%	136,782	4.190%
Variable Rate Funding:				
- PWLB	0		0	
- Market *	51,900		41,900	
- EIB	0		23	
- Temporary	26		7,726	
	51,926	4.642%	49,649	3.975%
Total Debt	**183,705**	**4.345%**	**186,431**	**4.133%**

* - Market Loans are shown as variable when they have less than 1 year to go until their next call date.

	31st March 2010		31st March 2009	
	Principal	Return	Principal	Return
	£000		£000	
Investments:				
- External	18,000	1.498%	40,000	5.106%
- Deposit Accounts	26,903	0.692%	1,797	0.500%
Total Investments	**44,903**	**1.015%**	**41,797**	**4.908%**

4.5 Performance Measurement

One of the key changes in the revision of the Code in 1996 was the formal introduction of performance measurement relating to investments, debt and capital financing activities. Whilst investment performance criteria have been well developed and universally accepted, debt performance indicators continue to be a more problematic area with the traditional average portfolio rate of interest acting as the main guide.

An alternative measure is the Council's Loans Fund Pool Rate for Interest which is used to allocate interest charges to the General Fund and reflects the actual cost of the Council's Treasury activities. The rates for the last 5 years are as follows:

Year	Loans Fund Pool Rate	Comments
2005/06	6.042%	
2006/07	5.859%	
2007/08	6.274%	Stock Transfer took place in 2007/08
2008/09	4.608%	
2009/10	3.805%	

As the above table shows, the rate for 2009/10 was 3.805% and this is the lowest that the Loans Fund Pool Rate has ever been.

4.6 Strategy For 2009/10

The Council's strategy for 2009/10 was based on a view that there was an intensifying global recession which would not only require central bank rates to be cut to unprecedented historically low levels, but could also require further action from central banks to reverse the downward path of economies.

The Bank Rate was expected to fall from 1% to 0.5% during the first quarter of 2009 and then to stabilise at 0.5% before starting to rise gradually with the first increase in the second quarter of 2010 and then to be up at 4% during the first quarter of 2012. There was, however, 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%.

- Longer-term interest rates
  The view on longer-term fixed interest rates (for 50 years) was that they would remain static around 3.90%-3.95% during 2009/10 with the 25 year rate being about 0.1% to 0.15% higher.

Against this background, and with regard to the level of Council investments, caution was to be adopted with the 2009/10 treasury operations. The Chief Financial Officer was to monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to Committee in quarterly reports.

4.7 The Economy In 2009/10 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 the 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 the Bank Rate and 3 month LIBID (an 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 quarter 3 of 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 to 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.

4.8 Borrowing Outturn For 2009/10

As previously reported to Committee, the Council has undertaken the following borrowing during the year:

October 2009

- £10,000,000 from the PWLB at 3.55% for 10 years

March 2010

- £5,000,000 from the PWLB at 2.85% for 5 years
- £5,000,000 from the PWLB at 3.37% for 6½ years
- £5,000,000 from the PWLB at 3.86% for 8½ years.

The above list excludes short-term borrowing undertaken as part of a debt restructuring exercise that took place in March/April 2009.

4.9 Debt Rescheduling

Rescheduling Strategy – The Council's treasury consultants 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. 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 the Bank Rate was kept at 0.5% all year. Running down cash balances would also mean reduced counterparty risk on the investment portfolio.

Rescheduling Outturn For 2009/10 – The Council undertook debt restructuring in March/April 2009 as reported to Committee in September 2009.

4.10 Compliance With Treasury Limits

During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Policy Statement, annual Treasury Strategy Statement, and the Treasury Management Practices apart from some short-term breaches as approved by Committee in September 2009. The outturn for the Prudential Indicators (for which outturn figures are required) is shown in Appendix 2.

4.11 Investment Rates and Outturn For 2009/10

Internally Managed Investments - The Council manages its investments in-house and invests with institutions that meet the approved counterparty criteria as included in the Council's Treasury Policy and Treasury Management Practices. The Council invests for a range of periods (normally from overnight to 364 days), dependent on the Council's cash flows, its interest rate view and the interest rates on offer. From 2010/11 investments are in compliance with the list of Permitted Investments approved by the Council, a requirement introduced by the Scottish Government.

Investment Strategy –The Bank Rate started on a downward trend from 5.75% in December 2007 with further cuts until February 2009 to reach 1%. A further cut of 0.5% was expected during Q1 of 2009. It was then expected to stabilise at 0.5% until starting to rise gradually with the first increase in Q2 of 2010 and then to be back up to 4% during Q1 of 2012. The Council's treasury consultants advised that Councils should therefore avoid locking into longer term deals while investment rates are down at historically low levels and advise that for 2009/10 clients should budget for an investment return of 1.5% on investments placed during 2009/10.

Members should note that Officers continue to monitor market news and movements on bank credit ratings and take advice from the Council's treasury advisers as to the implications for the Council of particular market moves, changes in credit ratings, or banking news. None of the movements or news has as yet required the Council to move funds or led to any changes in Treasury Policy but continued caution is, understandably, being adopted.

Investment Outturn for 2009/10 – The result of the investment strategy undertaken by the Council is as follows:

Average Investment	Rate of Return (gross of fees)	Benchmark Return (7-day LIBID uncompounded)
£43,000,000	2.37%	0.42%

The Council have outperformed the benchmark by 1.95% resulting in additional income to the Council of £838,500.

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

4.12 Other Issues

The Council's contract with its treasury advisers, which ran until 30th June 2009, was extended for a further 2 years.

5.0 IMPLICATIONS

5.1 Legal: None. Any borrowing or lending is done under the Council's legal powers.

Finance: Through the achievement of exceeding the investment benchmark return rate, the Council has benefited from additional returns of £838,500. The Council utilises Treasury Management as part of the overall Financial Strategy and Officers will continue to investigate borrowing and investment opportunities to bring financial benefits to the Council, all within the Treasury Management Policy.

Human Resources: None.

Equalities: None.

6.0 CONSULTATIONS

6.1 This report has been produced based on advice from the Council's treasury advisers (Sector Treasury Services Limited).

7.0 LIST OF BACKGROUND PAPERS

7.1 CIPFA - Code of Practice on Treasury Management 2001
CIPFA - Code of Practice on Treasury Management in the Public Services (Revised 2009)
Inverclyde Council – Treasury Management Strategy 2009/10.

Appendix 1

TREASURY MANAGEMENT
GLOSSARY OF TERMS

Affordable Capital Expenditure Limit
The amount that the Council can afford to allocate to capital expenditure in accordance with the requirements of the Local Government in Scotland Act 2003 and supporting regulations.

Authorised Limit for External Debt
This is a limit for total Council external debt as set by the Council based on debt levels and plans.

Bank of England
The central bank for the UK with ultimate responsibility for setting interest rates (which it does through the Monetary Policy Committee or “MPC”).

Bank Rate
The interest rate for the UK as set each month by the Monetary Policy Committee (“MPC”) of the Bank of England. This was previously referred to as the “Base Rate”.

Capital Expenditure
Expenditure on or for the creation of fixed assets that meets the definition of Capital Expenditure under the accounting rules as set-out in the annual Statement of Recommended Practice (SORP) and for which the Council are able to borrow.

Capital Financing Requirement
This is a Prudential Indicator that can be derived from the information in the Council’s Balance Sheet. It generally represents the underlying need to borrow for capital expenditure.

CDS Spread
A CDS Spread or “Credit Default Swap” Spread is the cost of insuring against default by a Counterparty. Increases in the CDS Spread for a Counterparty may indicate concerns within the market regarding a Counterparty.

CIPFA
CIPFA is the Chartered Institute of Public Finance and Accountancy who produce guidance, codes of practice, and policy documents for Councils.

Consumer Prices Index
The Consumer Prices Index (“CPI”) is a means of measuring inflation (as is the Retail Prices Index or “RPI”). The Monetary Policy Committee of the Bank of England set the Bank Rate in order to try to keep CPI at or close to the target set by the Government (currently the target is 2%). The calculation of the CPI includes many items of normal household expenditure but the calculation excludes some items such as mortgage interest payments and Council Tax.

Counterparty
Another organisation involved in a deal i.e. if the Council enters a deal with a bank then the bank would be referred to as the “Counterparty”.

Credit Ratings
Credit ratings are indicators produced by a ratings provider (such as Fitch, Moody's or Standard & Poor's) that aim to give an opinion on the relative ability of a financial institution to meet its financial commitments. Credit ratings are not guarantees – they are opinions based on investigations and assessments by the ratings providers and they are regularly reviewed and updated. The Council makes use of credit ratings to determine which counterparties are appropriate or suitable for the Council to make deposits with.

European Central Bank
Sometimes referred to as “the ECB”, the European Central Bank is the central bank for the Eurozone and is the equivalent of the Bank of England. The European Central Bank sets interest rates for the Eurozone.

Eurozone
This is the name given to the countries in Europe that have the Euro as their currency. Interest rates in the Eurozone are set by the European Central Bank. The Eurozone is comprised of the following 16 countries: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

Fed Rate
This is the interest rate for the US. Rates for the US are set by the Federal Reserve (the central bank for the US and the equivalent of the Bank of England).

Federal Reserve
Sometimes referred to as “the Fed”, the Federal Reserve is the central bank for the US and is the equivalent of the Bank of England. The Federal Reserve sets interest rates for the US.

Fixed Rate Funding/Investments
This term refers to funding or investments where the interest rate that applies to payments or receipts of interest on the funding or investments is fixed and does not change.

Flat Yield Curve
A flat yield curve occurs where the yield for long-term investments is the same or similar to the yield for short-term investments – the period of the investment makes no or little difference to the yield on the investment.

Gilt Yields
A gilt yield is the effective rate of return that someone buying a gilt at the current market price will receive on that gilt. Since the market price of a gilt can vary at any time, the yield will also vary.

Gilts
Gilts are bonds (i.e. debt certificates) that are issued (i.e. sold) by the UK Government. When they issue gilts the Government sets the interest rate that applies to the gilt, sets when they will repay the value of the gilt, and it agrees to make interest payments at regular intervals until the gilt is repaid or redeemed. Gilts are traded in the financial markets with the price varying depending on the interest rate applicable to the gilt, when the gilt will be repaid (i.e. when it will mature), on base rate expectations, and on market conditions.

Gross Domestic Product
Gross Domestic Product (“GDP”) is a measure of the output of goods and services from an economy.

Incremental Impact of Capital Investment Decisions
These are Prudential Indicators that reflect the impact on Council Tax of movements in projected and estimated capital expenditure within and between financial years.

Inflation
Inflation is the term used for an increase in prices over time. It can be measured in various ways including using the Consumer Prices Index (“CPI”) or the Retail Prices Index (“RPI”).

Inverted Yield Curve
An inverted or negative yield curve shows long-term investments having lower yields than short-term investments (an investor gets a better yield by investing for a shorter period).

Investment Regulations
The Local Government in Scotland Act 2003 allows the Scottish Ministers to introduce Regulations to extend and govern the rules under which Scottish Councils may invest funds. The Local Government Investments (Scotland) Regulations 2010 have recently been produced and are proposed to come into effect on 1st April 2010.

LIBID
This is the London Interbank Bid Rate – an interest rate that is used between banks when they wish to attract deposits from each other.

LIBOR
This is the London Inter Bank Offering Rate – an interest rate that is used as a base for setting interest rates for deals between banks.

LOBO
This is a form of loan that the Council has with some lenders. The term is short for the phrase “Lender Option/Borrower Option”.

MPC
The MPC or Monetary Policy Committee is a committee of the Bank of England that meets each month (in a meeting over 2 days) to set the Bank Rate for the UK.

Negative Yield Curve
A negative or inverted yield curve shows long-term investments having lower yields than short-term investments (an investor gets a better yield by investing for a shorter period).

Net Borrowing Requirement
This is the difference between the Council’s net external borrowing and its capital financing requirement. Under the Prudential Code the Council’s net external borrowing should not, except in the short term, exceed its capital financing requirement. The Net Borrowing Requirement should therefore normally be a negative figure.

Operational Boundary
This is a level of debt set by the Council at lower than the Authorised Limit and which Council debt levels should not normally exceed during normal operations.

Positive Yield Curve
A positive yield curve shows long-term investments having higher yields than short-term investments (an investor gets a higher rate yield for investing for longer).

Prudential Code
Councils are required to comply with the CIPFA Prudential Code for Capital Finance in Local Authorities. These requirements include the production of Prudential Indicators. The Prudential Code was revised in November 2009 with the revisions including the reclassification of some Prudential Indicators as Treasury Management Indicators covered by the Treasury Management Code.

Prudential Indicators
Indicators set-out in the Prudential Code that will help Councils to meet requirements in relation to borrowing limits or which will help Councils demonstrate affordability and prudence with regard to their prudential capital expenditure.

PWLB
The Public Works Loan Board is a government agency and part of the Debt Management Office. The PWLB provides loans to local authorities and other specified bodies.

PWLB Rates
These are the interest rates chargeable by the Public Works Loan Board for loans. The rates for fixed rate loans are determined by the day on which the loan is agreed. The rates to be charged by the PWLB for loans are set each day based on gilt yields at the start of business each day and then updated at least once during the day.

Quantitative Easing
This is the creation of money by a central bank (such as the Bank of England) in order to purchase assets from banks and companies and boost the supply of money in an economy.

Ratings
Ratings are indicators produced by a ratings provider (such as Fitch, Moody's or Standard & Poor's) that aim to give an indication of the financial or operational strength of entities including financial institutions and even countries. Ratings are not guarantees – they are opinions based on investigations and assessments by the ratings providers and they are regularly reviewed and updated. The Council makes use of credit ratings to determine which counterparties are appropriate or suitable for the Council to make deposits with.

Repo Rate
This is another name for the Bank Rate as set by the Monetary Policy Committee.

Retail Prices Index
The Retail Prices Index ("RPI") is a means of measuring inflation (as is the Consumer Prices Index or "CPI"). The calculation of the RPI includes most of the same items as the CPI as well as some items not included in the CPI such as mortgage interest payments and Council Tax whilst excluding items that are in the CPI such as charges for financial services.

Sector
Sector Treasury Services Limited who are the Council's treasury management consultants.

Treasury Management Code
This is the "Treasury Management in the Public Services: Code of Practice" and is a code of practice for Council treasury management activities. It is produced by CIPFA and was revised in November 2009 with changes including the transfer of some Prudential Indicators from the Prudential Code into the Treasury Management Code as Treasury Management Indicators.

Treasury Management Indicators
These are Prudential Indicators specifically relating to Treasury Management issues that were reclassified following the revision of the Prudential Code in November 2009.

Treasury Management Practices (TMPs)
This is a Council document that sets out Council policies and procedures for treasury management as required by the Treasury Management Code. The Council also agrees an annual treasury management strategy that is submitted to Committee in accordance with the Treasury Management Practices.

Variable Rate Funding/Investments
Funding or investments where the interest rate that applies to payments or receipts of interest on the funding or investments varies on an agreed basis.

Yield
The yield is the effective rate of return on an investment.

Yield Curve
A graph showing the yield on investments plotted against the maturity period for investments:

- A positive yield curve shows long-term investments having higher yields than short-term investments (an investor gets a higher rate yield for investing for longer).
- A negative or inverted yield curve shows long-term investments having lower yields than short-term investments (an investor gets a better yield by investing for a shorter period).
- A flat yield curve occurs where the yield for long-term investments is the same or similar to the yield for short-term investments – the period of the investment makes no or little difference to the yield on the investment.

Finance Services
Inverclyde Council
July 2010.

Appendix 2

PRUDENTIAL INDICATORS

	2008/09	2009/10
	Actual	**Actual**
Capital Expenditure (Indicator 5)	£000	£000
Non – HRA	24,490	15,589
HRA #	0	0
TOTAL	24,490	15,589
Ratio of financing costs to net revenue stream (Indicator 1)		
Non – HRA	8.18%	7.48%
HRA #	0.00%	0.00%
Net borrowing requirement (Indicator 4)	£000	£000
As At 31 March	-40,024	-43,522
Capital Financing Requirement as at 31 March (Indicator 6)	£000	£000
Non – HRA ##	184,135	204,743
HRA #	0	0
TOTAL	184,135	204,743
Upper limit for total principal sums invested for over 364 days (Indicator 14)	£0	£0
# - The Council undertook Housing Stock Transfer during 2007/08. ## - The Indicator for 2009/10 includes PPP schools occupied from 2009/10 in accordance with accounting rules.		