Item No: 8.2	Classification: Open	Date: 9 July 2008	Meeting Name: Council Assembly
Report title:		Treasury Management Performance – 2007/08 Annual Report and Prudential Indicators for Capital Finance and Treasury Management	
Wards or Groups affected:		All	
From:		Finance Director	

RECOMMENDATION

1. That Council Assembly notes the 2007/08 outturn report on borrowing, investments, capital finance and prudential indicators.

BACKGROUND INFORMATION

2. Prudential indicators are estimates and limits on capital finance, borrowing and investments and part of a self-regulating regime brought in by the Local Government Act 2003, supporting regulations and guidance, and two codes issued by the Chartered Institute of Public Finance and Accounting, CIPFA, (the Prudential Code for Capital Finance in Local Authorities and the Code of Practice for Treasury Management). Council Assembly agreed the indicators and treasury strategy in February 2007, which were updated in February 2008. Under financial delegation, the Finance Director is responsible for managing all executive and operational decisions within the indicators and strategy.

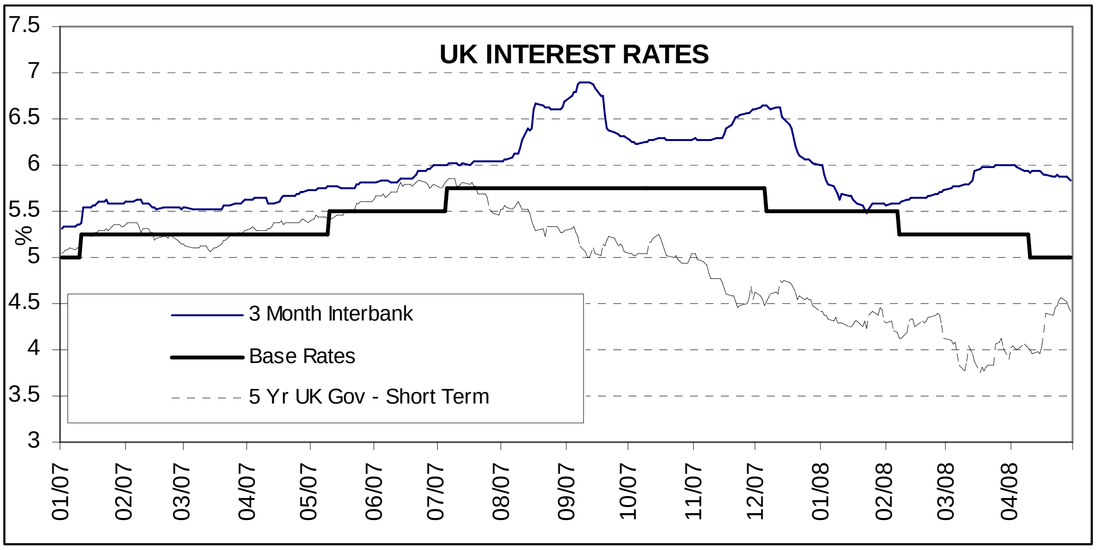
KEY ISSUES FOR CONSIDERATION

Treasury Management – Capital Funding, Debt Management and Investments

Developments in Financial Markets

3. Treasury management was carried out against a background of increased instability in the financial markets. In the summer of 2007 broad credit growth came to an abrupt end. Rising default rates in US sub-prime mortgages undermined confidence causing sharp falls in financial asset prices and acute financial difficulties for many financial institutions.

4. The cost of interbank borrowing relative to base rates rose to a peak in September 2007 and was at the time expected to return to normal levels by the end of the year. But as the chart below shows interbank borrowing relative to base rates remained expensive and as liquidity in structured credit products dried up, banks found themselves having to fund more long term credit exposure than expected. In turn expectations for growth were pared down as intense inflationary pressures from food, energy and commodities increased.



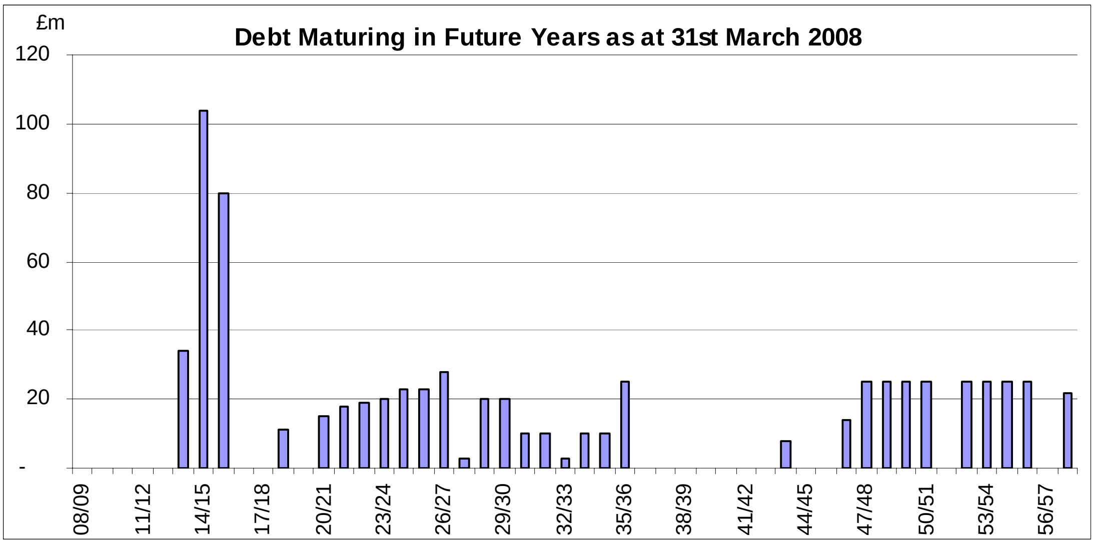
5. Monetary conditions were eased in response to these developments. In the US, rates were cut from 5.25% in summer 2007 to 2.0% in June 2008. Over the same period the Bank of England cut base rates from 5.75% to 5.0%. The European Central Bank kept its own base rates on hold, where previously expectations had been for rising rates. In addition central banks have increased the availability of funds to the banks. Short term Government bond yields have fallen in line with the expected path of base rates over much of 2007/08, but towards the end of the year yields have risen on expectation of rising inflation and expected base rate increases.

Capital Funding and Debt Management

6. The Council borrows to fund capital spend not met from capital receipts, grants or revenue contributions and to refinance debt outstanding from previous years' capital funding. Over the course of 2007/08 the total debt rose from £694m to £730m, made up of new supported borrowing for capital spend and the refinancing of existing debt.

7. A total of £36m was borrowed for new spend (£22m 50 yr loans at 4.45% taken in April 2007 and £14m 39 year loans at 4.49% taken in January 2008. The refinance replaced £200m existing debt, maturing between 2008 and 2014 (rates between 9% and 10.75%), with £200m new debt maturing between 2047 and 2055 (rates between 4.6% and 4.75%). Together this reduced the average rate of interest on debt from 8.8% in 2006/07 to 7.6% in 2007/08. The refinance involved premiums of £26m, 85% of which are reimbursable in housing subsidy payable in instalments spread over 7 years. The refinance only become viable after Government regulations made it possible to spread premiums over many years. Before that, accounting rules would have required premiums to be absorbed as an up front charge on the income and expenditure account and would have made it financially unsustainable to carry out the refinance.

8. The new debt and refinancing raised the average life of debt to 24 yrs (from 12 years 2006/07) and reduced near term refinancing requirements - no debt matures before 2014. The sums maturing each year at 31/3/08 are set out in the chart below. As in previous years all debt is from the Public Works Loans Board (PWLB - part of the UK Treasury) and at fixed rates. The Council was within approved prudential indicators for debt and within the operational debt limit, which was £800m.



Accounting Requirements

9. Although the principal sums owed to the PWLB stand at £730m at 31/3/08, under accounting standards on financial instrument introduced for the first time in 2007, the debt is carried on the balance sheet at £738m (the difference being part year interest due before 31/3/08 but payable after that). Again for accounting purposes, the fair value of the debt is £932m (made up of £193m premiums, £9m accrued interest and £730m principal). The fair value is higher than the principal sum on account of the Council's historical average rate of interest being higher than market rates prevailing at valuation date. Fair value varies around 12.4% for each one percent change in interest rate. Fair value and changes to it do not impact on the income and expenditure account and government support continues to be paid on the actual liability - 85% of actual interest paid is reimbursed as housing subsidy and the rest partially supported through formula grant.

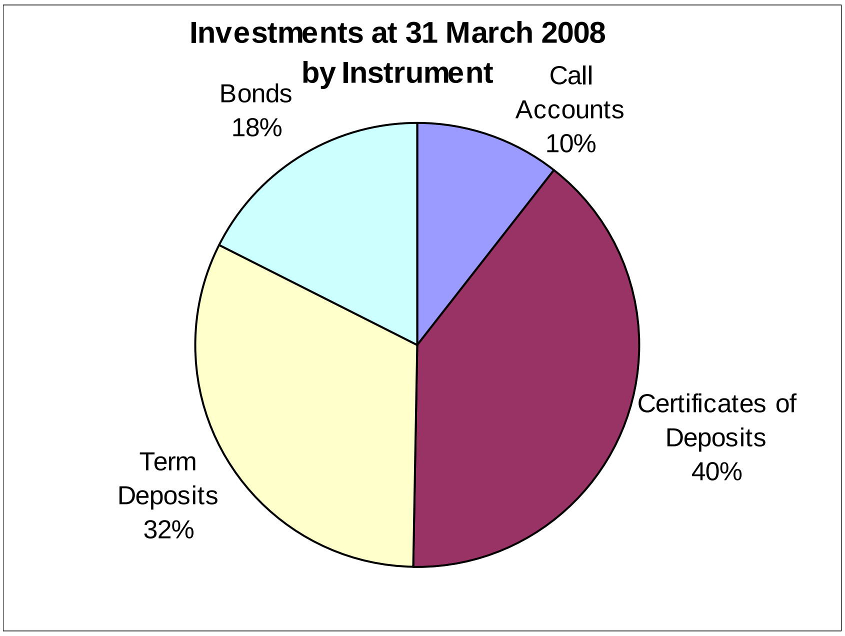
Investment Management

10. Cash balances averaged £298m over the course of 2007/08 (£306m 2006/07). Day to day investment management is carried out by an in-house operation and three investment management firms: Invesco Asset Management Ltd (part of the large UK investment group AMVESCAP), AllianceBernstein Ltd (part of AllianceBernstein Holding a large US based global investment management group and majority owned by AXA Financial, the financial group) and Credit Suisse Asset Management Ltd (part of Credit Suisse, the large Swiss based international banking and investment group).

11. External managers provide access to liquid instruments and maturities beyond one year through certificates of deposits and bonds, and expertise to help the Council enhance long term returns, with capital preservation, liquidity, low market risk and prudence as priorities, all within the investment strategy agreed by Council Assembly.

12. During the year, in compliance with the annual investment strategy, investments were spread over several high-rated institutions, in the interest of capital preservation. The actual counterparty exposure together with long term rating (issued by Fitch, the rating agency) and maturity analysis of the £273.6m in investments at 31/3/08 is shown below.

INVESTMENT MATURITY PROFILE & RATING				
	FITCH RATING			
Year Maturing	AAA	AA+ to AA-	A+	Sum £m
4-5 Yr	3%			7.4
3-4 Yr	0%			1.2
2-3 Yr	6%			15.5
1-2 Yr	2%			5.5
<1 Yr	7%	79%	3%	244.0
Total	18%	79%	3%	273.6



COUNTERPARTY EXPOSURE ACROSS MANAGERS at 31 MARCH 2008						
COUNTERPARTY	RATING	ALLIANCE BERNSTEIN	CREDIT SUISSE	INVESCO	IN-HOUSE	TOTAL
ALLIANC & LEIC PLC	A+	5.2	-	-	-	5.2
ALLIED IRISH BANKS	AA-	2.6	4.0	6.6	10.4	23.6
BANK OF IRELAND	AA-	5.2	5.1	-	-	10.3
BANK OF MONTREAL	AA-	-	-	2.0	-	2.0
BANK OF SCOTLAND	AA+	-	-	4.0	20.1	24.1
BARCLAYS	AA	4.5	-	6.5	11.0	22.0
CREDIT AGRIC IND	AA	-	-	5.0	-	5.0
DEUTSCHE BANK	AA-	5.2	-	5.1	15.6	25.9
EUROPEAN INVT BK	AAA	6.2	6.6	-	-	12.8
HSBC-CASH	AA	0.1	0.1	-	-	0.2
INT BK RECON & DEV	AAA	5.7	-	-	-	5.7
INTESA SANPAOLO SPA LOND	AA-	-	5.0	-	-	5.0
LLOYDS	AA+	2.4	5.0	-	-	7.4
NATIONWIDE BLD SOC	AA-	5.2	-	-	10.1	15.3
NORDEA BANK	AA-	-	-	4.1	-	4.1
SOCIETE GENERALE	AA-	5.2	-	-	-	5.2
UBS	AA-	-	-	6.2	10.4	16.6
UK GTD EXP FIN CORP	AAA	2.4	-	-	-	2.4
UK TREASURY	AAA	2.5	18.8	6.1	-	27.4
UNICREDITO ITALIANO LON	A+	-	3.0	-	-	3.0
RABOBANK	AA+	-	-	-	11.0	11.0
DEXIA	AA+	-	-	3.3	-	3.3
SANTANDER CEN HISP/ ABBEY	AA-	-	5.0	6.8	-	11.8
RBS/ NATWEST	AA	-	-	-	24.3	24.3
Total £m		52.4	52.6	55.7	112.9	273.6

13. The overall return on investments for 2007/08 was 6.1%, against average base rates of 5.5%, benefiting from higher interbank rates as well as reductions in bond yields referred to above. The funds held by external managers are more sensitive to rate movements than in-house funds on account of their longer life and fund values vary by around 0.8% for each 1% change in rates, while the value of in-house funds varies by around 0.1% for the same change in rates.

Prudential Indicators Outturn 2007/08

14. Estimates and limits on borrowing and investments are combined with capital finance in a series of prudential indicators. An analysis of these indicators for 2007/08 is out in Appendix A. The Council was within all limits and indicators.

SUPPLEMENTAL ADVICE FROM OTHER OFFICERS

Strategic Director of Legal and Democratic Services

15. The Local Government Act 2003 and supporting regulations require local authorities to determine annual borrowing limits and have regard to the Prudential Code for Capital Finance in Local Authorities, and the Code of Practice on Treasury Management, both published by the Chartered Institute of Public Finance and Accountancy, when considering borrowing and investment management strategies, determining or changing borrowing limits or prudential indicators. Reference should also be made to the Department of Communities and Local Government (DCLG, previously the ODPM) Guidance on Local Authority Investments issued in 2004.

16. The Council Assembly is responsible for determining or changing borrowing limits and indicators. However, no changes are being proposed in this report.

BACKGROUND DOCUMENTS

Background Papers	Held at	Contact
Prudential Code for Capital Finance in Local Authorities. Code of Practice on Treasury Management in the Public Services ODPM Investment Guidelines.	Financial Management Services, Strategic Services Department	Dennis Callaghan, Chief Accountant (020 7525 4375)

APPENDICES

No.	Title
Appendix A	Prudential Indicators for Capital Finance & Treasury Management– Detailed Analysis and Outturn - 2007/08

AUDIT TRAIL

<table>
<tr><td>Lead Officer</td><td colspan="2">Duncan Whitfield, Finance Director</td></tr>
<tr><td>Report Author</td><td colspan="2">Simon Hughes, Assistant Finance Director</td></tr>
<tr><td>Version</td><td colspan="2">Final</td></tr>
<tr><td>Version Date</td><td colspan="2">25/6/08</td></tr>
<tr><td>Key Decision</td><td colspan="2">Yes</td></tr>
<tr><td colspan="3">CONSULTATION WITH OTHER OFFICERS / DIRECTORATES / EXECUTIVE MEMBER</td></tr>
<tr><td>Officer Title</td><td>Comments Sought</td><td>Comments Included</td></tr>
<tr><td>Strategic Director of Legal and Democratic Services</td><td>Yes</td><td>Yes</td></tr>
<tr><td colspan="2">Final Report Sent to Constitutional Support Services</td><td>26/06/08</td></tr>
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APPENDIX A

Prudential Indicators for Capital Finance & Treasury Management – Detailed Analysis and Outturn - 2007/08

1. Capital finance, borrowing and investment arrangements are brought together in a series of prudential indicators and limits to give a general picture of the affordability, prudence and sustainability of financing activities. There are 10 indicators grouped into three broad areas or criteria of affordability, prudence and treasury management.

2. This Appendix provides an explanation of each indicator and the outturn for 2007/08, drawn from the Council's statement of accounts for the year. Projections were last updated in February 2008

CRITERIA ONE: AFFORDABILIY AND PRUDENTIAL INDICATORS ON AFFORDABILITY

INDICATOR ONE:

ESTIMATES OF RATIO OF FINANCING COSTS TO NET REVENUE STREAM

The financing ratio reflects financing costs arising from past and current capital expenditure funded from borrowing and income from cash balances. The GF ratio continued to reflect firm cash balances and investment returns. The different pattern of the HRA and GF ratios reflects the different way the two services are organised under legislation.

Financing Ratios	2006/07 Actual	2007/08 Previous Projection	**2007/08 Actual**
HRA	34.9%	33.0%	**33.0%**
GF	-0.7%	-1.0%	**-1.4%**

INDICATOR TWO:

ESTIMATES OF THE INCREMENTAL IMPACT OF CAPITAL INVESTMENT ON THE COUNCIL TAX AND HOUSING RENTS

Additional budgetary requirements for the capital programme may arise from self-financed prudential borrowing, which unlike supported borrowing is entirely funded from the Council's revenue budget. No self-financed prudential borrowing was carried out in 2007/08 and there was no additional impact on council tax or rent.

Prudential Indicators for Capital Finance & Treasury Management – Detailed Analysis and Outturn - 2007/08

CRITERIA TWO: PRUDENCE AND PRUDENTIAL INDICATORS FOR PRUDENCE

INDICATOR THREE:

ESTIMATES OF CAPITAL EXPENDITURE

The actual capital expenditure for 2007/08 was £140m, well below previous projections. The capital programme is currently being re-profiled and a detailed outturn report prepared for the Executive in September 2008.

Capital Expenditure	2006/07 Actual £m	2007/08 Previous Projection £m	**2007/08 Actual £m**
HRA	79	93	**76**
GF	69	92	**64**
Total	148	185	**140**

INDICATOR FOUR:

ACTUAL AND ESTIMATES OF CAPITAL FINANCING REQUIREMENTS.

Comment and Recommended Indicator

Both the HRA and the GF capital financing requirements (CFR) reflect the use of borrowing to pay for past and current capital expenditure. The increase since 2006/07 reflects supported borrowing approvals for capital borrowing £26m (all supported: £13m HRA, £13m GF) less the sum set aside for debt repayment £3m, GF only.

CFR	2006/07 Actual £m	2007/08 Previous Projection £m	**2007/08 Actual £m**
HRA	601	614	**614**
General Fund	106	116	**116**
Total	707	730	**730**

Prudential Indicators for Capital Finance & Treasury Management – Detailed Analysis and Outturn - 2007/08

INDICATOR FIVE:

ACTUAL DEBT- THE AUTHORISED AND OPERATIONAL LIMITS

Comment and Recommended Indicator

There are two limits on debt and long term liabilities outstanding on any one day. The lower limit is the operational boundary and takes account of ordinary activity. The authorised limit is the higher limit to accommodate unexpected borrowing that may be needed for very short periods. The total authorised limit is the limit councils have to determine under the Local Government Act 2003. The Council was within these limits, which for consistency are all presented at nominal value, the actual sums owed, rather than fair value.

Operational Boundary and Authorised Limits for External debt -	2006/07 Actual Max £m	2007/08 Previous Boundary/ Limit £m	**2007/08 Actual Max £m**
Operational Boundary for Debt			
Borrowing	717	800	**730**
Other long term liabilities	0	16	**0**
Total Operational	717	816	**730**
Authorised Limit for Debt -			
Borrowing	717	840	**730**
Other long term liabilities	0	17	**0**
Total Authorised	717	857	**730**

CRITERIA THREE: TREASURY MANAGEMENT

INDICATOR SIX:

ADOPTION OF THE CIPFA CODE OF PRACTICE ON TREASURY MANAGEMENT IN THE PUBLIC SERVICES

Comment and Recommended Indicator

This indicator confirms that the council has adopted the Code of Practice for Treasury Management in the Public Sector issued by CIPFA and updated in 2002.

INDICATORS SEVEN, EIGHT & NINE:

INTEREST RATE EXPOSURES – UPPER LIMITS ON FIXED RATES
INTEREST RATE EXPOSURES – UPPER LIMITS ON VARIABLE RATES
MATURITY LIMITS ON DEBT

Comment and Recommended Indicator

Council debt currently consists entirely of fixed rate loans, with very little falling for repayment over the next few years. Exposure to the three limits (fixed, variable and upper + lower maturity limits) was in line with expectations.

Prudential Indicators for Capital Finance & Treasury Management – Detailed Analysis and Outturn - 2007/08

Limits on Fixed and Variable Rates	2006/07 Actual Maximum £m	2007/08 Limit £m	**2007/08 Actual Maximum £m**
Upper limit for fixed interest rate exposure	717	840	**730**
Upper limit for variable rate exposure	0	210	**0**

Maturity Limits on debt	2006/07 Actual	2007/08 Upper Limit	2007/08 Lower Limit	**2007/08 Actual**
under 12 months	0%	25%	0%	**0%**
12 months and within 24 months	0%	30%	0%	**0%**
24 months and within 5 years	21%	60%	0%	**0%**
5 years and within 10 years	39%	80%	0%	**30%**
10 years and above	40%	80%	0%	**70%**

<u>INDICATOR TEN:</u>

TOTAL PRINCIPAL SUMS INVESTED FOR PERIODS LONGER THAN 364 DAYS.

Comment and Recommended Indicator

The Council's cash balances averaged £298m over the course of 2007/08. Exposure to investments beyond one year diversifies investments and helps raise returns. Actual exposure in 2007/08 reflected interest rate prospects and the low volatility and capital preservation nature of the investment strategy.

Upper limits on investments greater than 1 yr		
2006/07 Actual max Exposure	2007/08 Limits	**2007/08 Actual max exposure**
1-5 years: £12m 5-10 years: £0 m	Up to 50% of investments. Overall average maturity 3 years, but any one investment may be longer as referred to in the Annual Investment Strategy	**16% of investments greater than 1 year** **Overall maximum average maturity 8 months** **Longest investment 8 yrs**