DERBY CITY COUNCIL

AUDIT AND ACCOUNTS COMMITTEE
3 DECEMBER 2009

ITEM 13

Report of the Corporate Director of Resources

TREASURY MANAGEMENT PROGRESS REPORT 2009/10

RECOMMENDATION

1.1 To note the progress report on Treasury Management for the period to 30 September 2009.

SUPPORTING INFORMATION

2. Background

2.1 This is the first report on Treasury Management to be taken to the Audit and Accounts Committee, and this follows a recommendation made by the Audit Commission – reported to the Audit and Accounts Committee in June - that council members be more involved in treasury management investment and borrowing issues.

2.2 The financial markets have been marked by continued caution in the wake of the Icelandic collapse. Despite central government encouragement, banks remain reluctant to lend to each other and to businesses in general since there is still a lot of confusion surrounding the value of certain assets that might turn out to be over stated and not realisable.. Until all of this is unpicked by the banking sector and we return to a stable financial position again, financial activity will remain sluggish.

2.3 In addition to this, the UK economy is undergoing its longest recession since records began in 1955 with shrinking in six consecutive quarters. This is exerting a downward pressure on short-term interest rates as the Bank of England is reluctant to do anything that might be harmful to the process of recovery. Meanwhile, UK Government borrowing, to provide the funds necessary to prop up the ailing economy, is increasing massively and this is exerting an upward pressure on long-term interest rates.

2.4 As a consequence of this, the underlying interest rate being achieved by the Council in its investments is around 0.5%, contrasting starkly with the rates of around 6% being achieved at the same time last year. Fortunately, a number of these 6%-rated investments were long-term and therefore remain on the Council's books. This raises the average interest rate on investments for 2009/10, and the forecast outturn average rate for the year is currently 1.7%.

2.5 In line with previously agreed policy, the Council has allowed its cash balances to run down by redeeming a large amount of PWLB debt and delaying any new borrowing. As a result of this, the average investment balance for the first half of 2009/10 was around £97m, significantly lower than the corresponding figure for last year of £187m. This reduces interest charges and also makes it easier to place investments within a much-tightened counterparty list. However, relative to its capital programme the Council will be ‘under borrowed’ by around £102m by the year end and this borrowing requirement will have to be carried into 2010/11 or beyond.

2.6 Debt redemption on such a large scale is no longer such an attractive proposition because, once a certain threshold is reached, the amount of interest that is charged to the Housing Revenue Account - HRA (and which is covered by HRA subsidy) is reduced. This means that the benefits accruing to the general fund are lessened as more and more debt is redeemed. It is therefore not proposed to continue with this strategy.

2.7 The overall effect of all these factors is to push up the cost of borrowing and reduce the income receivable on investment balances. This is having an adverse effect on the Council’s treasury management budget. To illustrate this, the costs in 2008/09 were approximately £10.5m; these are now forecast to rise to around £15.7m in the current year and to around £21m by 2012/13.

3 Investments

3.1 In a report to Cabinet on 25 November 2008 it was reported that the size of the Council’s investment balances had been steadily increasing over time, due mainly to the Council’s increasing capital programme financed by borrowing, and delays in the actual expenditure of the borrowed funds.

3.2 At the time it was noted that these balances had a beneficial impact on the budget, generating a substantial amount of investment income. But it was also noted that security of investment was of greater concern than rate of return, and consequently that it was desirable to run these balances down to around £100m.

3.3 The table below shows that this has been achieved.

Financial Year	Balance at midpoint	Change on previous year
2003/04	£62.4m	
2004/05	£110.4m	+78%
2005/06	£108.3m	-2%
2006/07	£130.9m	+21%
2007/08	£152.6m	+17%
2008/09	£172.7m	+13%
2009/10	£97.0m	-44%

As highlighted in paragraph 3.5 above, this has only been achieved through the active redemption of debt – some £81m in the last 12 months – and not simply through delaying further borrowing.

3.4 In the wake of the Icelandic Banks collapse, there remains a risk of holding large cash balances in any financial institution. The Council has slightly mitigated this risk by tightening up its lending criteria over the past year or so, but with a minimum investment of about £1m in any approved bank or building society, a loss of principal would still be a blow to the Council's budget.

3.5 Given this risk, and the current financial climate wherein interest rates on debt far exceed interest rates on investments, it is desirable to run cash balances down as far as is practicable without causing cashflow difficulties. It is therefore the intention to allow balances to fall to around £40m - £50m before any further borrowing is undertaken. The long term effect of this policy could result in higher borrowing costs should interest rates for borrowing rise sharply in the meantime. On balance, however, it is considered that the scale of the reduced costs and increased safety at present outweigh the risk of interest rates increasing in future.

3.6 The following investment activity had taken place as at 1 October 2009.

Value of investments held at 1 April 2009	£127.550m
Value of investments held at 30 September 2009	£96.985m
Average value of investments April – Sep 2009	£112.408m
Total interest earned on investments April – Sep 2009	£1,441,024
Average return on portfolio	2.564%
Average LIBID 7 day rate (for comparison)	0.448%
Average Bank of England base rate (for comparison)	0.500%

4 Borrowing

4.1 In general, the Council borrows only to finance its capital programme. The Council's strategy for borrowing takes account of:

- the latest regulatory framework
- the existing borrowing structure
- the potential borrowing requirement for the year
- sources of new borrowing
- current rates

4.2 The Council's original strategy for 2009/10 agreed by Cabinet in February 2009 identified a 2009/10 borrowing figure of £27m. This was based on the capital programme as reported to Cabinet and also took into account existing loans due to mature, an estimate of 2008/09 borrowing not yet taken out, and the provision for debt repayment.

4.3 Over the course of 2009 some £81m of PWLB borrowing has been redeemed with the intention of both reducing the risk which currently attends high cash balances and also making genuine revenue savings from reduction in interest payments. The gross ongoing revenue saving from these redemption exercises is approximately £2.7m per annum. Taking into account lost interest income from having reduced cash balances, the net savings figure is approximately £1.9m per annum. As mentioned in paragraph 3.6 above, it is not proposed to undertake further redemption exercises because the future benefits to the General Fund diminish over time, and – more importantly – the Council actually requires the cash to fund its capital programme.

4.4 Due to redemption of debt and slippage and other changes to the capital programme, the current borrowing position has increased to £102.2m. The table below summarises the movement from the original position in February 2009 to the current revised position.

	Feb 2009	Sep 2009
	£m	£m
Supported Capital Expenditure (Revenue)	8.9	10.2
Unsupported Borrowing	8.3	10.8
Gross Borrowing Requirement	**17.2**	**21.0**
Private Finance Initiative adjustment	-0.3	-0.3
Minimum Revenue Provision	-7.9	-7.8
Net increase in debt	**9.0**	**12.9**
Under-borrowing carried forward	7.0	11.4
2008/09 borrowing requirement	**16.0**	**24.3**
New loans taken out	-	-
Loans repaid	11.1	77.9
2009/10 borrowing requirement	**27.0**	**102.2**

Columns may not sum due to rounding

4.5 The treasury budget currently assumes that only £20m of this borrowing requirement will actually be taken in 2009/10, with the remainder carried forward as a requirement in 2010/11 or beyond. For the immediate future, most expenditure commitments will therefore be met from the Council's cash balances.

4.6 There is a high risk in carrying forward such a commitment, in that future interest rates on borrowing may increase sharply in the next year or so. In a healthier economic climate, it might be prudent to borrow this money now and invest it until required. However, the costs and risks of this mean this approach is to be avoided. The current budget forecast assumes future borrowing to be around 6%, and this may cover borrowing costs. However, the budget also assumes an 'under borrowed' position of £30m by the end of 2012/13; if the full extent of this borrowing is in fact required then there will be an additional impact on revenue of £0.9m in 2012/13, rising to £1.8m in 2013/14.

4.7 The Council holds no debt from the private sector. The amount of PWLB debt by the year-end is forecast to be £265.433m (excluding the £20m yet to be borrowed), at a weighted average loan rate of 4.547%. The maturity profile of the Council's debt is as follows:

Period remaining by year end	Debt Outstanding £m
Under 1 year	7.061
1 – 2 years	0.029
2 – 3 years	0.004
3 – 4 years	0.026
4 – 5 years	0.000
5 – 10 years	0.003
10 – 20 years	18.807
20 – 30 years	50.504
Over 30 years	189.000
Total	**265.433**

4.8 This shows a gap in the maturity profile in the period up to 10 years. This is where we would look to borrow in future to ensure an even spread of principal repayment over future years.

5 Treasury Management Strategy

5.1 The Treasury Management strategy for 2009/10 was agreed by Cabinet in February 2009, and amended in both the Contract and Financial Procedure Matters Report and the Treasury Management Annual Report agreed by Cabinet in July 2009.

5.2 The Annual Report revised the Council's counterparty criteria to allow the long-term (12 months or over) rating awarded by the various credit-rating agencies to be ignored when investing for short periods, which was felt to be sensible, as during the current risk climate we are investing for no longer than 6 months. It also allowed a sharper focusing on the Individual and Support ratings, which measure the available resources of the counterparties and their parent companies or Government, should liquidity problems arise.

5.3 This revision prudently allowed a small number of counterparties to be reinstated on the Council's lending list, and provided some investment headroom, whereas prior to the change almost all new investments were being placed with the Bank of England's Debt Management Office at around 0.25%. For information, the 2009/10 budget currently assumes an average rate for new investments of 0.5%.

5.4 The lending criteria for short-term investments are now as follows:

Short term	Long term	Individual	Support	Max period	Limit
F1+	-	A/B	1	1 year	£12m
F1	-	C	2	1 year	£8m
F1	-	E	3	1 year	£5m
• AAA rated Money Market Funds				n/a	£15m
• UK Government guaranteed institutions				Period of guarantee	£12m
• Debt Management Office				n/a	£75m

5.5 To date the Council has placed no new investment with any of the Government guaranteed banks (apart from Northern Rock), since it has been felt that the guarantee could be withdrawn at short notice (except in Northern Rock's case where a 3 month notice period must be given). However, we feel that, as the Government guaranteed institutions are in theory as secure as the Debt Management Office or any other local authority, investments left on call (ie. investments that can be withdrawn without notice) in these institutions would satisfy the Council's security criteria. Such investments could be withdrawn immediately by the Council if the Government guarantee itself was suddenly withdrawn.

5.6 By maintaining a prudent spread of investments in both the low risk / low return Debt Management Office and the relatively low risk / better return of the Government guaranteed institutions, it is hoped that the budgeted investment rate of 0.5% can be achieved.

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Background papers:	Cabinet reports 28 Jul 2009, 17 Feb 2009, 25 Nov 2008
List of appendices:	Appendix 1 – Implications

Appendix 1

IMPLICATIONS

Financial

1.1 As detailed in the report.

Legal

2.1 As detailed in the report.

Personnel

3.1 None.

Equalities Impact

4.1 None.

Corporate objectives and priorities for change

5.1 The objectives and outcomes of the Council's Treasury Management Strategy contribute to 'giving you excellent services and value for money'.