Kirklees COUNCIL

Name of meeting and date: Cabinet
Wednesday 16th June 2009

Council
Wednesday 24th June 2009

Title of report: Annual Report on Treasury Management 2008/09

Is it likely to result in spending or saving £250k or more, or to have a significant effect on two or more electoral wards?	Yes
Is it in the Council's Forward Plan?	No
Is it eligible for "call in" by Scrutiny?	Not applicable
Cabinet member portfolio	Cllr M Khan and Cllr K Pinnock

Electoral wards affected and ward councillors consulted: All

Public or private: Public

1. Purpose of report

Financial Procedure Rules require that the Council receives an annual report on Treasury Management activities each financial year. The report reviews borrowing and investment performance, Prudential Indicators and risk and compliance issues.

2. Key points

The financial year 2008/09 was a difficult year for those organisations with loans and/or investments. The Council had agreed strategies for both borrowing and investing before the start of the year and had to adapt these strategies as circumstances changed rapidly. This was done by reducing the level of investments and using these resources to replace new borrowing and to reduce existing borrowing. The available benchmarks all suggest the Council's performance on Treasury Management has been better than average.

3. Implications for the Council

The Council has taken account of the effects of falling interest rates into the current treasury management budget. Provision has been made in the accounts for possible default on the outstanding investment with Landsbanki.

4. Consultees and their opinions

None

5. Officer recommendations and reasons

Cabinet is asked to note the annual report on Treasury Management activities and refer it to Council in accordance with Financial Procedure Rules.

6. Cabinet portfolio holder recommendation

The report and recommendations be submitted to Council.

7. Next steps

Reported submitted to Council.

8. Contact officer and relevant papers

Dick Hewitson Director of Finance	01484 221124	(8601124)
Robin Goater Assistant Director of Finance	01484 221027	(8601027)
Tim Mitchell Accountancy Services Manager	01484 221177	(8601177)

CIPFA's Code of Practice on Treasury Management in the Public Services.
CIPFA's Prudential Code for Capital Finance in Local Authorities.
Local Government Act 2003.
The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008.
Public Works Loan Board Website.

Kirklees COUNCIL

1. BACKGROUND

1.1 The Council has adopted the CIPFA Code of Practice on Treasury Management and operates its treasury management service in compliance with this Code and various statutory requirements. These require that the prime objective of the activity is to secure the effective management of risk, and that borrowing is undertaken on a prudent, affordable and sustainable basis.

1.2 Financial Procedure Rules require that the Council receives an annual report on Treasury Management activities for the previous financial year. In reviewing performance, reference will be made to the Treasury Management Strategy, the Investment Strategy, and the Revenue Budget and Capital Plan reports approved by Council on 27 February and 25 June 2008.

2. MAIN ISSUES

<u>Borrowing and Investment Strategies</u>

2.1 The policies for borrowing and investing are intrinsically linked. At one extreme, the maximum an authority can borrow externally over the longer term is a level equivalent to its Capital Financing Requirement (CFR) that is its underlying need to borrow for capital purposes. If it chooses to borrow at this level, it will also be a fact that the authority would be investing externally to a maximum level that is an amount equivalent to its total reserves, balances and net creditors. At the other extreme, an authority can choose not to invest externally, but instead use these internal balances to effectively "borrow internally" and minimise external borrowing. In between these two extremes, an authority may have a mixture of external and internal investments and external and internal borrowing.

2.2 For 2008/09 the Council agreed to borrow up to its CFR. The reasons for following this policy rather than minimising external borrowing were largely twofold:-

- Firstly, under the prudential borrowing regulations, the Government has the right to impose restrictions on overall local authority borrowing, if it is felt to be in national economic interests. Although the method of control has not yet been clarified, it is quite possible that limits may be placed on external borrowing levels. If this is the case, authorities with low amounts of borrowing in relation to their CFR may be in a disadvantageous position. If the Government were to set limits on new external borrowing, the Council may be restricted as to its use of its "internal balances" (i.e. revenue balances, reserves and net creditors) because their use would compel the Council to replace them with additional borrowing. By externally investing "internal balances", the Council increases its external borrowing and thus safeguards its position if the Government introduces a policy of borrowing restrictions.

- Secondly, the external investment of balances has been more advantageous in terms of achieving budgetary benefits. The investment of these monies has earned a better return for the Council (sometimes over 2%) than could be achieved by minimising its borrowing.

Borrowing Strategy

2.3 In order to borrow up to its CFR, it was estimated that the Council would need to borrow around £46 million in 2008/09. Advice from the Council's treasury management consultants suggested that short-term rates for the year would average 5.27% and long-term rates might provide opportunities of rates below 4.5%. The approved borrowing strategy was to take a pragmatic approach, authorising the Director of Finance, under delegated powers, to take the most appropriate form of borrowing depending on the prevailing interest rates at the time.

Investment Strategy

2.4 It was estimated that the Council would have around £130m (reserves, balances and net creditors) to invest externally. This was to be invested in line with the approved counterparty policy, giving priority to security and liquidity, and was estimated to generate approximately £7.3m in investment income for the year.

Performance

2.5 2008/09 proved to be a very turbulent year for economies and financial markets worldwide. The UK along with many other countries entered a deepening recession and the banking sector experienced various collapses, bailouts and mergers. The Council itself has been unfortunate in having £1m invested in a failed Icelandic bank, even though the bank had high credit ratings at the time the investment was placed.

2.6 The predictions for short-term interest rates were reasonably accurate in the first half of the year. However, rates were cut rapidly after September in an attempt to counter the effects of the deepening recession in the UK economy. Base Rate averaged 3.62% for the year, opening at 5.25% and reducing to 0.5% by the end of March 2009. Long-term rates moved within a range of 3.86% to 4.84%.

Table 1. Interest rate movements 2008/09

		Base rate	50 year PWLB
2008	Apr	5.25%	4.43%
	Jul	5%	4.58%
	Oct	5%	4.64%
	Jan	2%	4.23%
2009	Apr	0.5%	4.57%

2.7 Although the reasons for borrowing up to the authority's CFR were still valid, as the banking crisis worsened during the year they were considered to be of lesser importance than pursuing a policy of protecting the Council's investments. It was also believed unlikely under the current circumstances that Central Government would impose any borrowing restrictions on local authorities.

2.8 Officers have worked within, but continuously adapted, the investment strategy for 2008/09 in order to reduce risk. For example, investment periods have been reduced, Money Market Funds utilised, counterparties with government guarantees favoured, and country limits introduced. However, the year has also seen the number of counterparties that the Council can invest with steadily reduce due to mergers, failures or credit downgrades, and it has come to the point where the existing counterparty list cannot sustain investment levels of much above £100m. For this reason and a general desire to reduce the Council's investment exposure, the Director of Finance decided not to take any new borrowing for 2008/09 and also decided to repay £15m in existing debt (details in Appendix 1). In this way, the Council has met its borrowing requirement by "internal" borrowing from balances, and thus reduce its level of external investments. The strategy for 2009/10 approved by Members on 25 February 2009 reflects a continuation of such actions.

Borrowing Performance

2.9 As a result of the above, long-term loans at the end of the year totalled £528.4m, a reduction of £25.0m over the year and £61m less than planned. Total interest payments were £30.6m for the year. Fixed rate loans account for over 87% of total long-term debt giving the Council stability in its interest costs.

2.10 The maturity profile for fixed rate long-term loans is shown in Appendix 2 and shows that no more than 10% of fixed rate debt is due to be repaid in any one year. This is good practice as it reduces the Council's exposure to a substantial borrowing requirement in future years when interest rates might be at a relatively high level.

2.11 The Council has £106.5m of LOBO (Lender's Option, Borrower's Option) Loans as at 31 March 2009. The way these loans work is that the Council pays interest at a fixed rate for an initial period and then the lender has the option in the secondary period to increase the rate. If the option is exercised, the Council can either accept the new rate or repay the loan. These agreements typically have initial periods up to 20 years and total periods up to 60 years.

2.12 Short-term loans at the end of the year totalled £9.1m (£1.8 million 31 March 2008). Total interest payments were £0.08m. The Council's temporary borrowing performance was monitored throughout the year, with the average temporary borrowing rate of 3.13% ending up lower than the average borrowing rate of authorities in the Benchmarking Club (3.52%) and lower than the weighted average 7 day London Interbank borrowing rate (4.41%).

2.13 The Council's average borrowing rate has steadily fallen over the last seven years as follows:

Table 2. Average rate of interest on borrowings 2002/03 to 2008/09

Year	Ave Borrowing Rate (interest only)	Ave Borrowing Rate (incl Premium writeoffs*)
2002/03	7.70%	7.87%
2003/04	7.36%	7.61%
2004/05	7.12%	7.35%
2005/06	6.71%	6.88%
2006/07	5.94%	6.13%
2007/08	5.73%	5.89%
2008/09	5.62%	5.66%

**premiums are incurred on the early repayment of borrowing and effectively equate to the remaining interest payments due on the loan repaid.*

Investment Performance

2.14 The Council's investments totalled £102.1m as at 31 March 2009, a reduction of £32.7m over the year and £61m less than planned. Details of these investments are shown in Appendix 3. The Council invested an average balance of £154.8m externally during the year, generating £8.1m in investment income. The Council's investment performance was monitored throughout the year, with the average lending rate of 5.23% being higher than the average investment rate of authorities in the Benchmarking Club (5.20%) and the weighted average 7 day London Interbank deposit rate of 3.87%.

2.15 The £1m invested in the failed Icelandic Bank (Landsbanki), due back on 23 January 2009, has not been received. The LGA are leading work on behalf of all local authority creditors. Current opinion is that local authority deposits will be classed as preferential creditors and on that basis, it is hoped to get over 90% of the monies back. However, there is a chance that this preferential status could come under legal challenge from other creditors.

Prudential Indicators

2.16 The Council is required by the Prudential Code to report to Members the actual prudential indicators after the year end. Appendix 4 provides a schedule of all the mandatory indicators. The Council operated within all the appropriate limits.

Risk and Compliance Issues

2.17 The Council has complied with all the relevant statutory, regulatory and internal requirements which limit the levels of risk associated with its treasury management activities. Officers have continually adapted investment policies during the year in order to minimise risk in view of the deepening crisis in the financial markets. The Council's adoption and implementation of both the Prudential Code and the CIPFA Code of Practice on Treasury Management means that its capital expenditure is prudent, affordable and sustainable.

2.18 The Council is aware of the risks of passive management of the treasury portfolio and, with the support of the Council's consultants, Sterling Consultancy Services, has proactively managed the debt and investments over the year. There is little risk of volatility of borrowing costs in the current debt portfolio as interest rates are predominantly fixed.

3. IMPLICATIONS FOR COUNCIL POLICY

There are no direct implications for Council policy.

4. IMPLICATIONS FOR COUNCIL GOVERNANCE

The Council may wish to review the delegation arrangements for Treasury Management. Certainly the Audit Commission is advocating a more direct involvement of elected members than is presently the case. It is proposed that a further report is prepared for the Cabinet incorporating a response to the Audit Commission's recent report on local authorities' involvement with Icelandic banks.

5. MONITORING AND REVIEW

This annual report is the final stage of monitoring Treasury Management activity in 2008/09.

R Hewitson
Director of Finance

Contact Officers:

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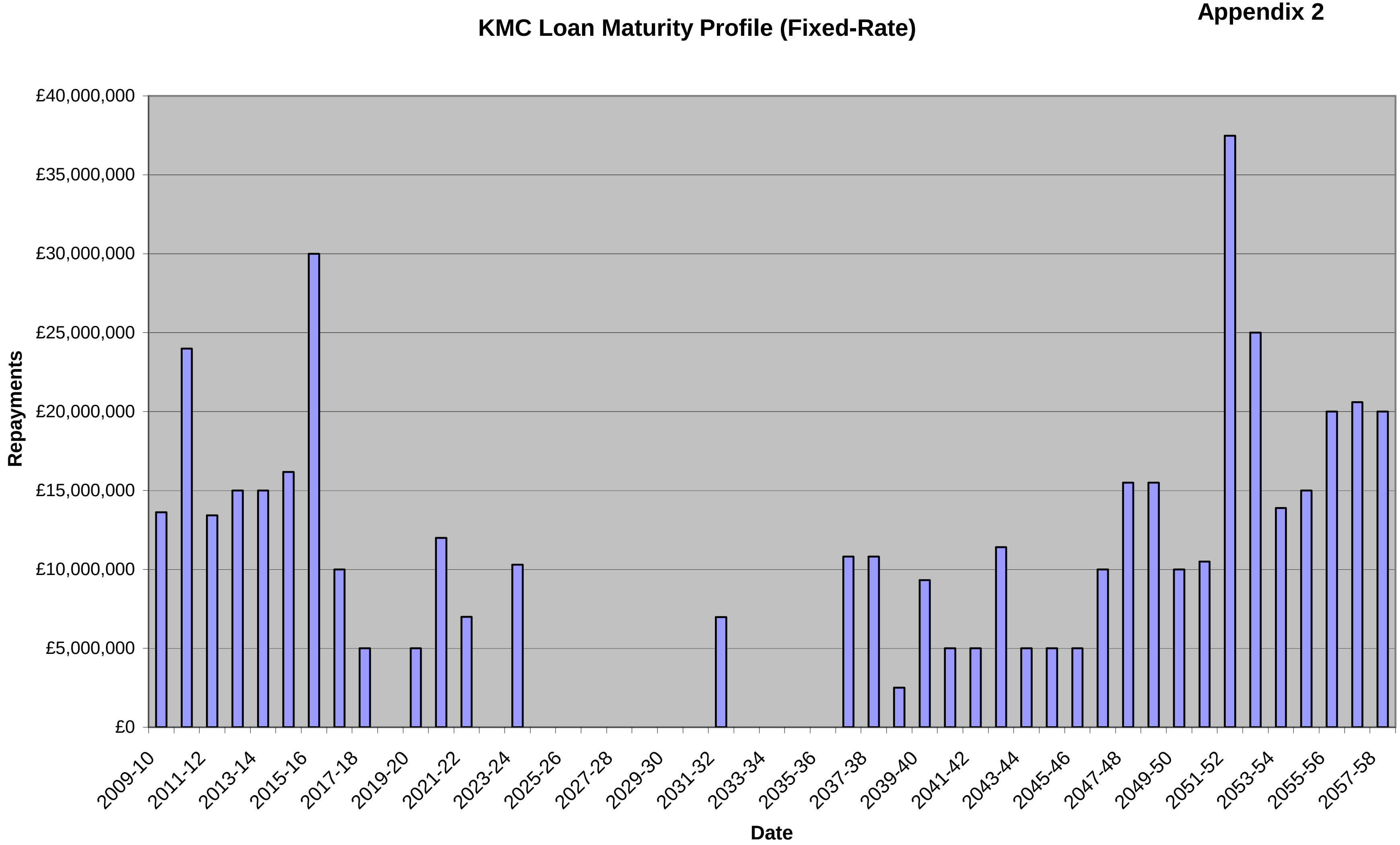
Tim Mitchell	01484 221177 (860 1177)

Loans Repaid 2008/09

	Rate %	Years to maturity	Date repaid	Amount £000s
PWLB (493204)	4.60	34	17 Oct 08	5,000
PWLB (493238)	4.80	24	17 Oct 08	4,184
PWLB (493323)	4.85	24.5	17 Oct 08	5,500
Net premium paid on above for early repayment				6
Total				**14,690**

Appendix 2



KMC Loan Maturity Profile (Fixed-Rate)
Repayments
£40,000,000
£35,000,000
£30,000,000
£25,000,000
£20,000,000
£15,000,000
£10,000,000
£5,000,000
£0
2009-10
2011-12
2013-14
2015-16
2017-18
2019-20
2021-22
2023-24
2025-26
2027-28
2029-30
2031-32
2033-34
2035-36
2037-38
2039-40
2041-42
2043-44
2045-46
2047-48
2049-50
2051-52
2053-54
2055-56
2057-58
Date

Investments as at 31 March 2009

Counterparty	£m	Interest Rate %	Terms	Date Invested	Maturity Date
Newcastle BS	1.0	6.32	Fixed	30/06/08	01/04/09
Dexia Bank	5.0	2.00	Fixed	06/01/09	01/04/09
Leeds BS	4.1	2.40	Fixed	06/01/09	01/04/09
Stroud & Swindon BS	1.0	3.00	Fixed	07/01/09	01/04/09
Chelsea BS	1.0	2.10	Fixed	15/01/09	01/04/09
Skipton BS	1.0	2.13	Fixed	15/01/09	01/04/09
DMO	2.4	0.30	Fixed	30/03/09	01/04/09
DMO	4.7	0.35	Fixed	31/03/09	01/04/09
City of Plymouth	4.0	1.25	Fixed	28/01/09	08/04/09
Newcastle BS	1.0	5.93	Fixed	12/09/08	14/04/09
Britannia BS	1.0	2.05	Fixed	22/01/09	16/04/09
Skipton BS	1.5	1.75	Fixed	16/02/09	16/04/09
Skipton BS	1.0	1.80	Fixed	16/02/09	16/04/09
Co-op	5.0	1.70	Fixed	20/02/09	16/04/09
West Bromwich BS	1.0	6.13	Fixed	22/07/08	22/04/09
Chelsea BS	1.0	5.34	Fixed	08/05/06	24/04/09
The Principality BS	2.0	6.00	Fixed	29/08/08	29/04/09
Barclays	5.0	1.90	Fixed	05/02/09	29/04/09
Nationwide BS	1.5	1.85	Fixed	17/02/09	29/04/09
Britannia BS	1.0	1.75	Fixed	27/02/09	29/04/09
Nottingham BS	1.0	1.85	Fixed	03/03/09	29/04/09
Skipton BS	1.4	1.73	Fixed	05/03/09	29/04/09
Skipton BS	1.0	1.80	Fixed	05/03/09	06/05/09
West Bromwich BS	1.3	6.12	Fixed	07/08/08	07/05/09
Norwich & Peterborough BS	1.0	6.04	Fixed	09/09/08	11/05/09
Northern Rock	1.0	6.00	Fixed	18/05/07	18/05/09
Stroud & Swindon BS	1.0	2.12	Fixed	05/03/09	27/05/09
Britannia BS	1.0	1.80	Fixed	05/03/09	27/05/09
Yorkshire BS	1.0	1.70	Fixed	05/03/09	27/05/09
The Principality BS	1.0	5.95	Fixed	05/09/08	05/06/09
NatWest	3.0	1.95	Fixed	05/03/09	05/06/09

Counterparty	£m	Interest Rate %	Terms	Date Invested	Maturity Date
Coventry BS	1.0	5.34	Fixed	08/12/06	08/06/09
Newcastle BS	1.0	5.40	Fixed	09/06/06	09/06/09
Skipton BS	1.0	6.54	Fixed	11/06/08	10/06/09
The Principality BS	1.0	6.45	Fixed	11/06/08	10/06/09
Nat Australia Bank	2.0	6.20	Fixed	20/06/08	19/06/09
Cheshire BS	2.0	6.41	Fixed	21/06/07	22/06/09
Chelsea BS	1.0	6.36	Fixed	28/06/07	29/06/09
Newcastle BS	1.0	6.05	Fixed	20/08/08	19/08/09
Norwich & Peterborough BS	2.0	6.06	Fixed	03/09/08	02/09/09
Yorkshire BS	1.0	6.00	Fixed	05/09/08	02/09/09
Dunfermline BS	1.0	6.35	Fixed	24/09/08	23/09/09
The Principality BS	1.0	6.00	Fixed	05/11/07	05/11/09
Lloyds TSB	2.5	5.85	Fixed	03/06/08	03/12/09
HSBC	4.0	2.25	Fixed	16/12/08	15/12/09
Lloyds TSB	1.3	2.00	Fixed	30/03/09	30/03/10
Cheshire BS	1.0	6.37	Fixed	28/06/07	25/06/10
Royal Bank of Scotland	2.0	6.57	Fixed	03/07/08	02/07/10
Northern Rock	1.0	6.84	Fixed	10/07/07	09/07/10
Barclays	2.0	6.03	Fixed	24/07/08	26/07/10
Barclays	1.0	6.30	Fixed	01/10/08	23/09/11
Landsbanki	1.0	5.46	Fixed	25/01/08	*23/01/09*
Norwich & Peterborough BS	1.0	3.21	Floating Rate	02/10/08	01/10/09
Dunfermline BS	2.0	2.54	Floating Rate	05/03/08	05/03/10
Royal Bank of Scotland	3.0	2.38	Callable Deposit	14/01/09	13/01/10
HSBC	5.0	1.30	Callable Deposit	03/03/09	02/03/10
HSBC	1.0	6.32	Callable Deposit	07/06/07	04/06/10
Alliance & Leicester	0.3	0.82	Deposit	n/a	n/a

Counterparty	£m	Interest Rate %	Terms	Date Invested	Maturity Date
Aviva Liquidity Fund	0.1	1.16	MMF	n/a	n/a
Standard Life LF	0.1	1.30	MMF	n/a	n/a
Total	**102.1**				

By Sector

	£	%
Bank	45,076,017	44.14%
Building Society	45,800,000	44.84%
Debt Management Office	7,100,000	6.95%
Local Authorities	4,000,000	3.92%
Money Market Funds	154,564	0.15%
	102,130,581	**100.00%**

By Country

	£	%
Australia	2,000,000	1.96%
Belgium	5,000,000	4.90%
Iceland	1,000,000	0.98%
Spain	253,992	0.25%
UK	93,876,589	91.92%
	102,130,581	**100.00%**

Prudential Indicators Actuals 2008/09

Capital Expenditure, Capital Financing Requirement and External Debt

The table below draws together the main elements of Capital Plan expenditure, highlighting the supported and unsupported elements of borrowing and other financing arrangements. The table also shows the Capital Financing Requirement (CFR), which is the Council's underlying external indebtedness for a capital purpose, compared with the expected borrowing position.

	2007/08	2008/09	
	Actual	**Estimate**	**Actual**
	£000s	**£000s**	**£000s**
Capital Expenditure			
HRA	24,735	21,000	17,291
General Fund	77,185	137,825	95,762
Total	**101,920**	**158,825**	**113,053**
Financed by -			
Supported Borrowing	13,577	15,642	15,642
Unsupported Borrowing	21,144	58,312	42,020
Capital Receipts	15,829	11,574	4,043
Capital Grant	29,282	54,371	37,218
Major Repairs Reserve (HRA)	8,174	7,068	3,025
Revenue	13,914	11,858	11,105
	101,920	**158,825**	**113,053**
CFR as at 31 March			
General Fund CFR	327,855	385,351	369,468
HRA CFR	240,994	240,994	240,994
Total CFR	**568,849**	**626,345**	**610,462**
External debt as at 31 March			
Borrowing	548,323	613,726	537,467
Other LT Liabilities	5,919	5,738	5,341
Total debt	**554,242**	**619,464**	**542,808**

The difference between the CFR and external borrowing reflects the amount of internal balances that are being "borrowed" to finance capital indebtedness.

Limits to Borrowing Activity

The first key control over the Council's borrowing activity is a Prudential Indicator to ensure that over the medium term, net borrowing will only be for a capital purpose. Net external borrowing should not, except in the short-term, exceed the total CFR. This allows some flexibility for limited early borrowing for future years. As can be seen from the table above, the Council kept its total debt within the CFR and this has also been the case in previous years.

A further two Prudential Indicators control the overall level of borrowing. These are the Authorised Limit and the Operational Boundary. The Authorised Limit represents the limit beyond which borrowing is prohibited. It reflects the level of borrowing which, while not desired, could be afforded in the short-term, but is not sustainable. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3(1) of the Local Government Act 2003.

The Operational Boundary is based on the probable external debt during the course of the year. It is not a limit and actual borrowing could vary around this boundary for short times during this year.

	2007/08	**2008/09**	
	Actual (max)	**Estimate**	**Actual (max)**
	£m	**£m**	**£m**
Authorised limit for external debt			
Borrowing	547.8	691.4	551.3
Other Long Term Liabilities	5.9	4.6	5.7
Total	**553.7**	**696.0**	**557.0**
Operational boundary for external debt			
Borrowing	547.8	617.4	551.3
Other Long Term Liabilities	5.9	4.6	5.7
Total	**553.7**	**622.0**	**557.0**

The Council was well within its Authorised limit and Operational Boundary for the year.

Affordability Prudential Indicators

<u>Ratio of financing costs to net revenue stream and impact of capital investment decisions on the Precept</u>

These indicators identify the cost of capital (borrowing costs net of investment income) against the net revenue stream, and the incremental impact of the capital programme. The net revenue stream for General Fund is defined as the amount to be met from government grants, local taxpayers and balances, and for HRA it refers to the total HRA income (rent, other income and subsidy).

	2007/08	2008/09	
	Actual	Estimate	Actual
<u>Ratio of financing costs to net revenue stream</u>			
General Fund	4.68%	5.50%	4.86%
HRA	36.01%	36.13%	34.82%
<u>Incremental impact of capital investment decisions</u>			
Council Tax (Band D)		£10.22	£7.23
HRA		0	0

Treasury Management Prudential Indicators

<u>Interest Rate Exposures</u>

While fixed rate borrowing can contribute significantly to reducing the uncertainty surrounding future interest rate scenarios, the pursuit of optimum performance justifies retaining a degree of flexibility through the use of variable interest rates on at least part of the treasury management portfolio. The Prudential Code requires the setting of upper limits for both variable rate and fixed interest rate exposure:

	Limit Set 2008/11	Actual 2008/ 09
Interest at fixed rates as a percentage of net interest payments	60% - 100%	90%
Interest at variable rates as a percentage of net interest payments	0% - 40%	10%

The interest payments were within the limits set.

Maturity Structure of Borrowing

This indicator is designed to prevent the Council having large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

Amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate	**Limit Set 2008/ 09**	**Actual Levels 2008/ 09**
Under 12 months	0% - 20%	1% - 3%
12 months to 2 years	0% - 20%	5% - 8%
2 years to 5 years	0% - 60%	6% - 9%
5 years to 10 years	0% - 80%	13% - 16%
More than 10 years	20% - 100%	70%

The limits on the proportion of fixed rate debt were adhered to.

Total principal sums invested for periods longer than 364 days

The Council agreed to invest sums up to £25 million for periods longer than 364 days up to a period of three years. This limit was not broken during the year and as at 31 March 2009, the Council had £8.0 million invested in periods for a year or longer.