Report to: **Cabinet**

Subject: **Annual Treasury Activity Report 2008/09**

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1. PURPOSE OF REPORT

To inform Members of the Annual Treasury Activity Report as required by the Treasury Management Strategy, and the outturn in respect of the Prudential Indicators.

2. BACKGROUND

Gedling Borough Council fully complies with the requirements of the CIPFA Code of Practice on Treasury Management 2001, which has been formally adopted by the Council. The primary requirements of the code are:

- The creation and maintenance of a Treasury Management Policy Statement, which sets out the policies and objectives of the Council's treasury management activities.

- 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.

- Receipt by Council of an annual Treasury Management Strategy Statement (TMSS) for the year ahead, and an Annual Report detailing the Treasury activities for the previous year.

- 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.

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."

3. ANNUAL TREASURY ACTIVITY REPORT 2008/09

(3.1) The Council's current treasury position

The Council's debt and investment position at the beginning and end of the year 2008/09 is shown at Appendix 1.

(3.2) Performance Measurement

One of the key changes in the revised Code of Practice in 2001 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

The use of benchmarks such as the 12-month LIBID for investments may be inappropriate for local authorities with relatively small cash balances, as they are generally able to place funds for only short periods and often at lower rates. The 7-day LIBID rate is considered more appropriate as the relevant benchmark for Gedling's investments. The 7 day uncompounded LIBID rate for 2008/09 was 3.70% and the Council's in-house managed funds achieved an overall equated rate of 4.96%, out performing the benchmark by 1.26%. As a further comparison, the 3 month uncompounded LIBID rate was 4.49%. This out-performance was the result of several investments made towards the top of the market, timed in accordance with advice from the Council's treasury advisers. The cushioning effect of these advantageous rates will continue into the first part of 2009/10.

During 2008/09, significant core balances and the active management of cash-flows resulted in no temporary borrowing being undertaken. Gedling's limited number of borrowing transactions and the absence of average borrowing rates for model portfolios, means that the Council needs to develop benchmarks in this problematic area. Similar to investments, the market does produce a 7-day LIBOR rate for the annual cycle and this is suggested as the benchmark against which future temporary borrowing should be measured.

The Council's treasury management borrowing performance is in reality dominated by its long-term borrowing activity. The amount to be borrowed is directed by the Council's capital expenditure plans approved as part of the annual budget, therefore, performance is best measured by looking at the timing of long-term borrowing, which can be controlled by use of temporary treasury activity.

During 2008/09, no new long-term borrowing was undertaken. Following the LSVT in November 2008, overhanging debt grant arrangements enabled the redemption of £3.985m of outstanding PWLB debt by CLG on the Council's behalf, and in addition, the sum of £1.703m matured naturally.

The Council continues to take advice with regard to its borrowing activity from Sector Treasury Services.

(3.3) The strategy for 2008/09

The Treasury Management Strategy Statement (TMSS) for 2008/09 was based on a view of the rate of growth of GDP in the UK would decline from a peak of 3.3% in Q3 of 2007 to 2% in 2008. Bank Rate was expected to continue falling from 5.75% in November 2007 to reach 5% in Q2 of 2008, and then stay there for the rest of the financial year 2008/09. This was based around the dilemma facing the MPC of balancing the opposing risks of inflationary pressures driven by spikes in oil prices, against concerns around the impact of the credit crunch both on the UK housing market and economy, and even more so, on the US housing market and economy and the knock on impact on world growth rates.

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 be stable at 5.25% in 2008/09, based on a balance of risks around rising inflationary pressures on one hand, and falling growth rates and concerns over the impact of the credit crunch on the other.

Longer-term interest rates - The view on longer-term fixed interest rates at 50 years was that they would remain static around 4.45% for the whole year. The 25-year rate would also remain flat around 4.50% to 4.55%.

The agreed TMSS, based upon the above forecasts, was that the borrowing strategy for 2008/09 should be either to take very long-dated borrowing at any time during the financial year, since 50 year borrowing rates should be marginally lower than those for 25 years, or alternatively to take marginally more expensive 25 year borrowing, in order to maximise any future rescheduling potential since the spread between the

new borrowing and early repayment rates in this area was considerably less. Variable-rate borrowing was expected to be more expensive than long-term fixed rate borrowing, and would therefore be unattractive throughout the financial year.

Against this background, caution was to be adopted and a pragmatic approach taken to any changing circumstances.

(3.4) The economy in 2008/09

2008/09 was a year that can only be described as unparalleled and extraordinary. The financial crisis, commonly known as the “credit crunch”, had a major downward impact on the levels of interest rates around the world. Although rates initially fell sharply in the USA, they were followed eventually by the Bank of England.

On 1 April 2008, Bank Rate was 5% and the Bank of England was focused on fighting inflation. Market fears were that rates were going to be raised as CPI, the Government’s preferred inflation measure, was well above the 2% target (two years ahead). The money market yield curve reflected these concerns with one year deposits trading well above the 6% level. PWLB rates in both 5 and 10 years edged above Bank Rate during the summer of 2008 as markets maintained their belief that inflation was the major concern of the monetary authorities. The money markets were reflecting some concern about liquidity at this time and the spread between Bank Rate and 3-month LIBOR was greater than had historically been the case.

This phase continued throughout the summer until 15 September, when Lehmans Brothers, a US investment bank, was allowed to file for bankruptcy in the total absence of any other institution being willing to buy it due to the perceived levels of toxic debt it held. This event caused huge shock waves in world financial markets and threatened to completely destabilise them. It also led to an immediate spike up in investment rates as markets grappled with the implications this might have for other financial institutions, their credit standing, and indeed their viability. On 7 October, the Icelandic government took control of their banks and this was followed a few days by the UK government pumping a massive £37bn into three UK clearing banks (RBS, HBOS and Lloyds), as liquidity in the markets dried up. The Monetary Policy Committee meanwhile reduced interest rates by 50bp on 9 October. This had little impact on 3-month LIBOR, however, as the spread or “disconnect” as it became known, against Bank Rate widened out. Short term PWLB rates fell dramatically as investors, concerned about their counterparty limits post the Icelandic banks collapse, fled to the quality of government debt, forcing yields lower.

Market focus now shifted from inflation concerns to concerns about recession, depression and deflation. Although CPI was still well above target, it was seen as no barrier to rates being cut further. The MPC duly delivered another cut in interest rates in November, this time by an unprecedented 1.5%. Investors continued to pour money into government securities across the curve, at the front end because of credit concerns, and at the longer end because of the economic consequences reducing inflation, driving yields in 10-year PWLB temporarily below 4% and 5-year to around 3.5%. In December, as the ramifications of the credit crunch became increasingly clear, the Bank of England cut interest rates to 2%, a drop of 1%. The whole inter-bank yield curve shifted downwards but the “disconnect” at the short end remained very wide, negating to some degree the impact of the cuts in Bank Rate. 50-year PWLB rates dropped below 4% at the turn of the year, marking the low point in this maturity.

The New Year of 2009 brought little relief to the prevailing sense of crisis, and on 8 January the MPC reduced rates by 0.5% to 1.5%, a record low. More Government support for the banking sector was announced on 19 January 2009. The debt markets had a sharp sell-off at this stage, as they took fright at the amount of gilt issuance likely to be needed to finance the help provided to the banks. There was also discussion about further measures that could be introduced to kick start lending and economic activity. These included “quantitative easing” by the Bank of England, effectively printing money.

In February 2009 the MPC adopted the traditional method of monetary easing by cutting interest rates again by 0.5%, to 1%. Inter-bank rates drifted down, with the spread in the 3-months still well above Bank Rate. In early March, Lloyds Banking Group, which now included HBOS, took part in the Government Asset Protection scheme. The MPC cut rates yet again to 0.5% and announced that the quantitative easing scheme would start soon. This scheme would focus on buying up to £75bn of gilts in the 5-25 year maturity periods, and £10-15bn of corporate bonds. This led to a substantial rally in the gilt markets, particularly in the 5 and 10 year parts of the curve, and PWLB rates fell accordingly. Finally at the end of March it was announced that the Dunfermline Building society had run into difficulties and its depositors and “good” mortgages were taken over by Nationwide, whilst the Treasury took on its doubtful loans.

The financial year ended with markets still badly disrupted, the real economy suffering from a lack of credit, short to medium term interest rates at record lows, and a great deal of uncertainty as to how or when recovery would take place. Investment income returns had been badly hit, but lower borrowing rates in short to medium term periods ad allowed indebted authorities to benefit.

(3.5) Borrowing and investment rates in 2008/09

12-month bid rates: One year LIBID fluctuated between around 5.7% and 6.4% with two peaks driven by credit crunch fears in June and September 2008. Bank Rate had been held at 5% until 9 October, when the first of a series of major cuts caused 12-month LIBID in 2008/09 to be on a rapidly falling trend to the end of the financial year, reaching 1.85% at the end

Longer-term interest rates – The PWLB 45-50 year rate started the year at 4.43% (25 year at 4.62%), and was then generally within an band of 4.3% to 4.6% (4.6% to 5%) until mid October when there was a spike up to 4.85% (5.08%), followed by a plunge down to 3.86% in early December (4.03% in late December). Further spikes of 4.84% (4.86%) and 4.72% (4.69%) occurred in late January and early February, with the year closing out at 4.58% (4.28%). It was not uncommon to see rates fluctuating by as much as 40-50 basis points within a week during 2008/09.

(3.6) The Borrowing outturn for 2008/09

The Council undertook no new borrowing during 2008/09. An underlying need to borrow can still be demonstrated by the Capital Financing Requirement, and advice will continue to be taken from Sector Treasury Services with regard to the timing of any future borrowing.

Overhanging Debt Grant arrangements enabled the redemption of £3.985m of outstanding PWLB debt by CLG on the Council's behalf. In addition, £1.703m of PWLB debt matured naturally.

No temporary borrowing was undertaken during the year. Over the course of the year, increasing use was made of the Council's surplus cashflow balances, in an effort to be proactive regarding risk, and this will continue to be the case.

(3.7) Compliance with treasury limits and Prudential Indicators

During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Policy Statement and annual Treasury Management Strategy Statement (TMSS). The outturn for the Prudential Indicators is shown at Appendix 2.

(3.8) Investment outturn and activity for 2008/09

During 2008/09 the Council managed its investments in-house, and invested with the institutions listed on the Council's approved lending list. All investments were made in accordance with the Council's in-house investment strategy, as agreed in the TMSS for 2008/09.

In the light of the unprecedented impact of the credit crunch, and rapidly changing credit ratings, close attention was paid to any institution that moved in or out of the agreed range. The collapse of Lehmans and the Icelandic banking system created an environment of fear in the markets, and the nationalisation, or part- nationalisation, of many financial institutions was necessary to secure the global financial system in the face of hundreds of billions o f pounds worth of toxic asset related losses.

The default of the Icelandic banks in October 2008 led the Council to review its credit policy, and a report was presented to Members in order to reassure them that the Council had not held investments in any Icelandic institution, and that it was being proactive in seeking to minimise risk. For example, when advice was received that the Irish sovereign rating was under threat, no further deposits were made with Irish institutions, but existing loans were all allowed to mature. Equally however, when it became clear that HBOS/BOS was significantly in public ownership, and represented minimal risk despite falling outside the normal credit criteria, specific approval was sought to continue its inclusion on the approved lending list.

Investments were made for a range of periods, dependent on cashflows, views on interest rates, and the interest rates actually on offer. Early in the year before rates fell, several advantageous deals were achieved for one year investments. These rates cushioned the effect of the historically low rates on offer at the end of the year, and will similarly enhance performance to some extent during 2009/10. From October onwards, investments tended to be kept short to minimise risk and maximise liquidity.

A summary of the Councils investments during 2008/09 can be found at Appendix 1 and show that the actual average interest rate received was 4.96%, which compares favourably with both the 7 Day LIBID benchmark rate of 3.70%, and to the 3 month LIBID rate of 4.49%.

(3.9) Icelandic Banks

As referred to above, the Council had no investments in any Icelandic bank at the time of the banking collapse in October 2008.

(3.10) Debt Rescheduling

On 1 November 2007, PWLB radically changed the structure of their rates. At this point they imposed two rates for each period, one for new borrowing and a new, significantly lower, rate for early repayment of debt. The differential between the two rates ranged from 26bp in the shorter dated maturities to over 40bp in the longer ones. They also introduced

daily movements of 1bp instead of 5bp, and rates in half-year periods throughout the maturity range (previously this had been mainly in five-year bands).

Sector Treasury Services started 2008/09 with the expectation that the 25 and 50-year PWLB rates would vary little during the year. The main way for making savings was therefore to consider the potential for moving PWLB debt into alternative instruments, eg. LOBOs, at lower rates. This did not prove to be viable due to the credit crunch.

Taken together, these events effectively prevented the Council from restructuring any of its portfolio into either new PWLB borrowing, or alternative instruments, and accordingly no debt rescheduling was undertaken in 2008/09.

(3.10) Other Issues

On 3 November 2008 the Council completed a Large Scale Voluntary Transfer of its housing stock to Gedling Homes. No capital receipt was generated by this transfer due to the level of outstanding improvement works, however Overhanging Debt Grant arrangements enabled the redemption of £3.985m of PWLB debt by CLG on the Council's behalf.

4. RECOMMENDATION

Members are asked to:

Note the above Annual Treasury Activity Report for 2008/09, and to refer it to Council for approval.