**Report to:** **Council**

**Subject:** **Annual Treasury Activity Report 2007/08**

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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 2007/08

### (3.1) The Council’s current treasury position

The Council’s debt and investment position at the beginning and end of the year 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 2007/08 was 5.58% and the Council’s in-house managed funds achieved an overall equated rate of 5.75%, out performing the benchmark by 0.17%. As a further comparison, the 3 month uncompounded LIBID rate was 5.92%.

Gedling’s relatively limited number of borrowing transactions and the absence of average borrowing rates for model portfolios, means 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 that temporary borrowing should be measured against. For 2007/08, Gedling’s average temporary borrowing rate was 5.44% against a 7 day LIBOR rate of 5.71%. Performance was favourable against the benchmark despite the Council taking only seven short-term loans covering a total period of only 12 days. This is due to all the seven loans being taken in the early part of the year, before interest rates rose.

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.

As detailed later in this report, the Council took £2.5m of additional long term borrowing during the year. Due to extremely favourable rates, this was in anticipation of the underlying requirement for borrowing as demonstrated by the Capital Financing Requirement, and following advice from Sector Treasury Services.

**(3.3) The strategy for 2007/08**

The Treasury Management Strategy Statement (TMSS) for 2007/08 was based on a view of the rate of growth of GDP in the UK continuing to be steady at trend during the year. Bank rate was expected to remain steady at 5% until the final quarter of the year when it would fall to 4.75%. This was predicated on CPI being at target on the two-year horizon, that wage growth would be below the MPC's threshold of 4.5%, that GDP trend growth would be higher due to inward migration and that the US economy would ease back in 2007. Risks to the upside would include house prices continuing to rise, wage pressures rising in response to inflationary pressures and utility prices continuing to be higher.

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 trend growth in the UK, US and EU would eventually lead to a decrease in UK Bank Rate from 5% to 4.75% by the end of March 2008.

**Longer-term interest rates** - The view on longer-term fixed interest rates at 50 years was that they would remain static around 4.25% for the whole year. The 25-year rate would also remain flat around 4.5%.

The agreed TMSS, based upon the above forecast, was that the borrowing strategy for 2007/08 should be to take very long-dated borrowings at any time during the financial year. Variable-rate borrowing, and borrowing in the five-year area, were expected to be more expensive than long-term 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 2007/08

**Shorter-term interest rates** – Bank Rate started 2007/08 at 5.25% with expectations that there would be further increases in rates. This was reflected in a positive interbank money market curve. A further increase in rates to 5.5% duly occurred on 10 May 2007, but not before the Governor of the Bank of England had written a letter to the Chancellor in April, explaining why CPI had risen to1% or more above the official CPI inflation target of 2%. The Bank of England's inflation report, issued in May, showed inflation would be above target at the two-year horizon. Another rise was delivered on 5 July 2007, when Bank Rate rose to 5.75%, and the markets, including Sector, fully expected Bank Rate to increase again. One year Interbank was priced at over 6%, GDP growth was continuing to strengthen, and the housing market was still robust. The August inflation report showed Bank Rate needed to rise to 6% to keep inflation at target in two years time.

August, as it turned out was the peak of interest rates, as what has become known as the "credit crunch" hit the markets and the global economy. The crunch originated in the US through the sub-prime housing market. Although originating in the US, investors worldwide, particularly banks, had invested in packages of sub-prime loans, attracted by the high yields offered. Fears arose that a large number of these investments would turn out to be worthless and this in turn would lead to bankruptcies among the banking sector. As a result of these fears, and the ensuing reluctance of banks to lend to each other, the Federal Reserve Bank injected $38bn of liquidity into the markets on 9 August. The ECB followed suit but the Bank of England stood on the sidelines, only making cash available at a penal rate of 1% above Bank Rate. On 17 August the Federal Reserve cut interest rates by 50bp to 5.25%. On 20 August, Sector revised its interest rate view to reflect a downside risk to its forecast. The dislocation in the markets continues throughout the summer until on 14 September it was announced that the Bank of England had provided billions of pounds of financial support to Northern Rock, which had been affected by the drying up of the wholesale money markets which provided 80% of its funding. On 17 September the Chancellor announced a Government guarantee for all deposits held at the stricken bank. A day later, the Federal Reserve cut US rates by a further 50bp, although oil rose to $80 a barrel and continued to climb, briefly reaching a peak of $100 a barrel in November.

On 24 September, Sector revised its interest rate forecast with 5.75% now the peak in rates. At its October meeting, the MPC declined to cut Bank Rate, being concerned about the inflation outlook. UK data continued to be robust during the autumn, although CPI dropped to 1.8% in September. The 3-month LIBID still remained well above Bank Rate. On 31 October the Federal Reserve cut rates yet again, to 4.5%, and the following day they added $41bn of reserves to free up the markets. The MPC eventually cut Bank Rate on 6 December to 5.5% as concerns about the economy and the credit crunch

mounted. On 10 December both UBS and Capital Economics revised their interest rate forecasts down sharply. A day later, the Federal Reserve cut rates again, this time by 25bp.

2008 was ushered in with major fears about the global economy. Stock markets fell sharply and government bond yields fell. On 22 January the Federal Reserve cut rates, this time by a massive 75bp to 3.5% and once more on 30 January to 3%. The MPC followed suit in February, cutting Bank Rate by 25bp to 5.25%. On 18 February it was announced that the Government would nationalise Northern Rock. In late February and March, the markets seized up again, forcing concerted liquidity intervention by the world's central banks, initially to little avail. The UK budget brought increased debt issuance, but little else, pushing gilt yields up sharply at the front end, driving PWLB rates up. On 14 March, US bank Bear Stearns had to be bailed out by the Federal Reserve, culminating in a takeover by JP Morgan. The year ended with the money markets anxious and nervous, and 3-month cash at 75p above Bank Rate.

**Longer-term interest rates** – The PWLB 45-50 year rate started the year at 4.45% and fell to a low of 4.38% in March 2008. The high point, of which there were several, for 45-50 year was 4.90% before finishing the year at 4.42%. The volatility in yields was a direct reflection of the massive change to the interest rate sentiment brought about by the sub-prime crisis in the US. A radical change to the PWLB structure was introduced by the DMO on 1 November, when they moved to single basis point moves in their rates, and introduced a separate repayment rate at the same time. This was at a level significantly below the rate at which they would lend new money.

## (3.5) Borrowing and investment rates in 2007/08

**12-month bid rates**: One year LIBID was on a rising trend until September 2007. Initially the increase was due to the interest rate outlook and the expectation that the MPC would need to increase rates to counter inflation. The sub-prime crisis then took over as lenders became nervous about lending for longer periods. The one-year rate reached over 6.5% in September 2007 before easing back to just over 5.5% by the end of the calendar year. In 2008, interest rate expectations veered towards cuts in rates again and so the one-year moved down to 5.1%. Following the February Bank Rate cut and the inflation report, it edged back up again to 5.4% and continued higher to 5.8% in March as Interbank markets seized up again.

**Longer-term interest rates** – The PWLB 45-50 year rate started the year at 4.45% (25 year at 4.65%) and fell to a low of 4.38% in March 2008 (25 year low was 4.45% in January). The high point, of which there were several, for 45-50 year was 4.9% (25-30 year had several highs of 5.15% in June/July

2007) before finishing the year at 4.42% (25-30 year 4.6%).

**(3.6) The Borrowing outturn for 2007/08**

The Council undertook new borrowing of £2.5m during 2007/08 as detailed in Appendix 1. This was represented by borrowing in advance of need, due to the availability of extremely favourable rates. An underlying need to borrow can be demonstrated by the Capital Financing Requirement, and advice was received from Sector Treasury Services before any transaction was undertaken.

A small amount of temporary borrowing was undertaken early in the financial year for cashflow purposes.

**(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. The indicators for the ratio of financing costs to net revenue stream both show some variation. The reduction with regard to non-HRA is due both to the timing of PWLB borrowing in 2007/08, and to the achievement of significantly higher investment interest receipts. The increase with regard to HRA is due to a higher revenue contribution to capital expenditure, and has been judged to be fully affordable.

**(3.8) Investment outturn and activity for 2007/08**

During 2007/08 the Council managed its investments in-house, and invested with the institutions listed on the Council's 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. All investments were made in accordance with the Council's in-house investment strategy, as agreed in the TMSS for 2007/08.

The TMSS identified 5.6% as an attractive "trigger" rate for both 1 year and 2-3 year lending, and these trigger rates were kept under review with Sector Treasury Services. Sector was originally forecasting base rate to peak at 5.5% before falling back to 5% by the end of 2007. Actual Bank Rate started the year at 5.25%, peaking at 5.75% in July and then dropping back to 5.25% again in February 2008. The highest rate of interest achieved was 6.57%. Full use was also made of corporate deposit accounts and short-dated deposits (1-3 months), in order to benefit from the compounding of interest.

The majority of in-house managed funds are cashflow derived, however, there is a core balance available, which may be invested over a 2-3 year period if appropriate. Core balances remained healthy during 2007/08 due to borrowing in advance of need at advantageous rates, following advice from Sector Treasury Services. PWLB funds were taken at 3.87%, and then invested temporarily at rates in excess of 5.8% pending the capital expenditure being incurred.
A summary of the Councils investments during 2007/08 can be found at Appendix 1 and show that the actual average interest rate received was 5.75%, which compares favourably with the 7 Day LIBID benchmark rate of 5.58%, and given the level of cashflow only investment was encouragingly close to the 3 month LIBID rate of 5.92%.

**(3.9) Debt Rescheduling**

Sector Treasury Services started 2007/08 with the expectation that the 50-year PWLB would reach a level of 4.25% during the financial year, most likely towards the end of the period. Their advice was therefore to hold off borrowing longer dated debt until later in the year. By the end of June the forecast had been revised as the 50-year PWLB rose to around 4.85%, generating a revised recommendation to review taking long term borrowing at levels around 4.5%, although the forecast still allowed for rates to reduce to 4.25% later in 2007/08, With long term PWLB rates at these higher levels, the advice was to borrow (if borrowing was required urgently) at the short end of the inter-bank market even though Bank Rate was raised to 5.75% in this period. The turmoil that then hit the markets mid-year had a marked effect on PWLB rates for the rest of the financial year. Long term rates fell back to, and below, 4.5% (although not as low as 4.25%), while rates at the short end fell below 4% giving an opportunity to lock into yields of 4.25% and lower for periods as long as six years. LOBO structures also offered levels of 4.25% and even sub 4% during this period of unprecedented turmoil in the markets.

Rescheduling opportunities presented themselves until 1 November when the PWLB radically changed the structure of their rates. Up to that point there had been various opportunities to improve the terms of the debt holdings by restructuring adjacent periods, whilst being mindful of the requirements of the new SORP. Longer-term restructuring could only be done by moving into LOBOs, and only if the LOBO offered a rate of 4.25% or lower.

On 1 November the PWLB 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). These changes effectively prevented the Council from restructuring the portfolio into new PWLB borrowing, and accordingly no debt rescheduling was undertaken in 2007/08.

**(3.10) Large Scale Voluntary Transfer (LSVT)**

The Council has undertaken a ballot of its tenants with regard to the long anticipated LSVT, and has received a positive result. Accordingly, permission for this LSVT to proceed has been sought from the Government, with a view to a transfer in November 2008. Complex and critical decisions are currently being taken, and advice will be sought from Sector Treasury Services as necessary.

## 4. RECOMMENDATION

Members are asked to:

i. Approve the above Annual Treasury Activity Report

ii. To note the outturn in respect of the Treasury Limits and Prudential Indicators, shown at Appendix 2.