

**EAST AYRSHIRE COUNCIL**

**CABINET– 21 OCTOBER 2009**

**TREASURY MANAGEMENT ANNUAL REPORT FOR 2008/2009 AND UPDATE ON  
2009/10 STRATEGY**

**Report by Executive Head of Finance and Asset Management**

**1 PURPOSE OF REPORT**

- 1.1** To inform Cabinet of the treasury activity for the financial year ended 31 March 2009. The report also covers the actual Prudential Indicators for 2008/09 in accordance with the requirements of the Prudential Code, and provides an update on the 2009/10 treasury management strategy.

**2 BACKGROUND INFORMATION**

- 2.1** The Council's treasury management activities are regulated by professional codes of practice, statutes and guidance. The Council has adopted the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services Code of Practice. The Code places importance on the overall management of risks, including liquidity; interest rate and credit and counterparty risk and requires that authorities have in place robust treasury policies and practices to address these.
- 2.2** The Local Government in Scotland Act 2003 (the Act) provides the statutory authority to undertake borrowing and investment activity together with prescribing controls and limits for this. The Act permits the Scottish Ministers to impose limits either on the Council or at a national level on all local authorities restricting the amount of borrowing which may be undertaken. No restrictions were made in 2008/09 or indeed in previous years.
- 2.3** Statutory Instrument (SSI) 29 2004, requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities, and therefore to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services.
- 2.4** The Council undertakes capital expenditure to create, improve or enhance the life of its assets. These activities are funded from related income such as capital receipts from the disposal of assets, capital grants, and revenue contributions. Any residual which is not met from the application of such funding streams gives rise to an underlying borrowing need. This borrowing need will be charged to revenue over a number of years based upon the estimated life of the asset created. This area of capital expenditure activity is regulated by the CIPFA Prudential Code which requires actual outturn to be reported in the following areas:
- Capital expenditure;
  - Capital Financing Requirement;
  - Debt;
  - Ratio of financing costs to net revenue stream.

Additional indicators are included to ensure comprehensive annual reporting.

- 2.3** Part of the Council's treasury activities is to address any borrowing need, either through borrowing from external bodies, or utilising temporary cash resources within the Council. The wider treasury activities also include managing the Council's cash flows, its previous borrowing activities and the investment of surplus funds. These activities are structured to manage risk foremost, and then optimise performance in accordance with the CIPFA Code of Practice on Treasury Management.
- 2.4** The Code requires as a minimum the regular reporting of treasury management activities to: -
- (a)** Forecast the likely activity for the forthcoming year: - in this respect the annual strategy report was approved by Cabinet at its meeting on 22 March 2009.
  - (b)** Review actual activity for the proceeding year and comment on interim performance in the current financial year which is the purpose of this report.

### **3 TREASURY PERFORMANCE SUMMARY 2008/09**

#### **3.1 Economic and Interest Rate Summary 2008/09**

When the treasury strategy for 2008/09 was approved by Cabinet on 18 March 2009 there was a downward movement projected for interest rates with the base rate in particular forecast to move from 5 ¼ % at March 2008 to around 4 ¾ % by the end of the financial year. Inflation rose higher than had been expected during 2008/09 and the consumer price index (CPI) breached the limit of 3% set by the Bank of England Monetary Policy Committee reaching a high in August of 4.7%. This was in part driven by a sharp rise in the price of oil with other commodity prices also remaining high throughout the year.

During the second quarter of the year there was significant upheaval in the financial markets with sharp falls in the value of shares and stock in a number of institutions driven by investor perception. This problem escalated with the collapse of the Lehman Brothers Bank in September followed a few weeks later by the Icelandic Banks crisis. Action was taken by Governments and central banks such as the Bank of England to support the national financial systems including government backed capital support for a number of banks. A number of takeovers and mergers took place with the government becoming the majority shareholder in some cases – most notably Northern Rock and Royal Bank of Scotland.

In response to the prevailing economic conditions the Bank of England progressively cut the base rate reaching ½ % by March 2009. This however had only a very limited impact on the economy with the result that the Bank of England announced a programme of Quantitative Easing – whereby it would buy back £75Billion of government issued gilts the purpose of which was to lower the yield and ultimately the borrowing costs for the UK corporate sector. The movement in interest rates during 2008/09 showing the original forecast an actual performance is summarised in table 3.1 below.

INTEREST RATE FORECASTS & ACTUAL PERFORMANCE								
Year	Base Rate		5 Year Gilt		20 Year Gilt		50 Year Gilt	
	Estimate	Actual	Estimate	Actual	Estimate	Actual	Estimate	Actual
Mar-08	5.25%	5.25%	4.60%	3.89%	4.60%	4.57%	4.40%	4.21%
Jun-08	5.00%	5.00%	4.70%	5.17%	4.70%	5.05%	4.50%	4.38%
Sep-08	4.75%	5.00%	4.70%	4.19%	4.70%	4.68%	4.50%	4.40%
Dec-08	4.75%	2.00%	4.70%	2.44%	4.80%	3.96%	4.60%	3.64%
Mar-09	4.75%	0.50%	4.80%	2.35%	4.80%	4.03%	4.60%	4.32%

Table 3.1 – Summary Interest Rates

### 3.2 Capital Expenditure and Financing 2008/09

During 2008/09 the total capital investment undertaken by the Council was £40.995M. This forms one of the required prudential indicators, and the table below shows how this was financed with the resultant underlying need to borrow of £21.034M compared to the original estimate of £28.346m. The reason for this reduction was slippage within both the general fund and housing capital programmes along with additional capital grant received in year.

	2008/09 Estimate £M	2008/09 Actual £M	Variance £M
<b>Capital Expenditure</b>			
General Fund	28.889	25.388	-3.501
HRA	15.935	15.607	-0.328
<b>Gross Capital Expenditure</b>	<b>44.824</b>	<b>40.995</b>	<b>-3.829</b>
<b>Financed By:</b>			
Capital Receipts	-2.700	-2.848	-0.148
Grants & Partnership Funding	-5.036	-8.288	-3.252
Revenue (CFCR)	-6.769	-7.052	-0.283
Capital Fund – Appropriation	-1.973	-1.773	0.200
<b>Total Financing</b>	<b>-16.478</b>	<b>-19.961</b>	<b>-3.483</b>
<b>Un-financed capital expenditure (Borrowing Requirement in Year)</b>	<b>28.346</b>	<b>21.034</b>	<b>-7.312</b>

### 3.3 The Council's Overall Borrowing Need

3.3.1 The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This figure is a gauge for the Council's external debt position and represents all 2008/09 expenditure plus all historic net capital expenditure which has not yet been fully charged to revenue. The following table summarises the movement in the Council's Capital Financing Requirement (CFR) during 2008-09.

	General Fund £'M	Housing £'M	Total £'M
Opening balance 1 April 2008	150.402	57.635	208.037
Add : Un-financed capital expenditure 2008/09 (3.1 above)	14.619	6.415	21.034
Less : Principal repayments due in 2008/09 on historic debt	(7.721)	(0.801)	(8.522)
<b>Closing balance 31 March 2009</b>	<b>157.300</b>	<b>63.249</b>	<b>220.549</b>

### 3.4 Treasury Position at 31 March 2009

3.4.1 Whilst the Council's gauge of its underlying need to borrow is the CFR, authority is delegated to the Executive Head of Finance and Asset Management to manage the Council's actual borrowing position by either borrowing to finance the CFR, utilising some temporary cash flow funds or borrowing for future calculated increases in the CFR (borrowing in advance of need) based upon an assessment of current and future interest rate movement.

3.4.2 The external debt portfolio position of the council of the Council at 31 March 2009 compared to the previous year is shown in the following table.

	O/S @ 1 April 2008 £'M	Net movement in Debt Level £'M	O/S @ 31 March 2009 £'M
Public Works Loan Board	123.319	+11.911	135.230
Market Loans	66.600	-	66.600
Temporary Borrowings	-	-	-
European Investment Bank	0.085	-0.055	0.030
Trusts & Bequests etc.	0.801	+0.009	0.810
<b>TOTAL EXTERNAL BORROWING</b>	<b>190.805</b>	<b>11.865</b>	<b>202.670</b>
Short Term Investments	(41.200)	1.640	(39.560)
<b>NET EXTERNAL DEBT</b>	<b>149.605</b>	<b>13.505</b>	<b>163.110</b>

3.4.3 The tables at paragraph 3.2 and 3.3 indicate that there was no underlying need to borrow at 31 March 2009 as the CFR was £220.549m which exceeded the total external borrowing shown of £202.670m. During the year the increase in the level of Public Work Loan Board borrowing was the result of new borrowing of £18.000m at an interest rate of 4.39%, locking into this rate for a fixed period together with the early repayment of £6.065m generating a reduction in annual interest payments of approximately £0.275M.

3.4.4 In order to mitigate the risk as far as possible from interest rate movements, limits are in place which restrict the ratio of fixed to variable rate debt to 60:40. The table below analyses the external debt between fixed and variable rates of interest at 31 March 2009. The average interest rates shown are those as at 31 March 2009.

Category	Principal £'M	% of Total	Average Interest Rate %
Fixed Interest Rate Debt	166.260	82.03%	5.926%
Variable Interest Rate Debt	36.410	17.97%	4.808%
<b>Total External Debt</b>	<b>202.670</b>	<b>100.00%</b>	<b>5.725%</b>
<b>Investments</b>	<b>(39.560)</b>		<b>2.800%</b>
<b>NET EXTERNAL DEBT</b>	<b>163.110</b>		

3.4.5 The Treasury Management Strategy for 2008/09 identified a projected underlying borrowing requirement for the year of £20.238M. The table at paragraph 3.2.1 highlights that the actual borrowing requirement was £12.512M with the reduction of £9.135M being primarily due to slippage and additional capital grants received during the year.

3.4.6 The short term investments held at 31 March 2009 of £39.560m represent the general and specific reserves of the council combined with its working capital requirements as well as any difference between the councils need to borrow and its actual levels of external borrowing at any point in time. There was no significant movement in the level of short term investments during the year, which are shown net of the current provision for the impairment of the investments held with the Icelandic Banks which is currently calculated as £1.973M.

3.4.7 Current investment regulations restrict the placement of surplus funds to a maximum period of 364 days. Given the general volatility in the investment market from October 2008 onwards investments were only placed with those institutions defined as eligible institutions under the credit guarantee scheme. Investment activity is managed on a daily basis and over the year to 31 March 2009 the average investment balance held was £48.986M with an average return of 5.45%.

### 3.5 Performance Indicators

3.5.1 The headline performance indicator for treasury management is the average cost of servicing loans as reflected in the consolidated loans fund interest and expenses rate – the pool rate. The performance over the last 3 financial years calculated in accordance with LASAAC guidance is shown below.

Year	Opening Advances £'M	Closing Advances £'M	Average Advances £'M	Interest & Expenses £'M	Pool Rate %
2006/07	182.414	187.541	188.425	11.405	6.05%
2007/08	187.541	208.037	197.789	12.168	6.15%
2008/09	208.037	220.550	214.294	11.813	5.52%

3.5.2 The reduction in the pool rate from 6.15% in 2007/08 to 5.52% in 2008/09 is due to lower overall interest and expenses during the year arising partly from lower levels of interest being credited to internal accounts due to a combination of expenditure profiles and lower interest rates together with an increase in the overall level of capital debt which was financed by borrowing in the final quarter of the financial year.

### 3.6 Prudential Indicators and Compliance Issues

3.6.1 It is a requirement of The Prudential Code that the actual prudential indicators for the financial year 2008/09 are reported to members. A number of these indicators provide either an overview or a limit on treasury activity attributing limits to ensure that external borrowing remains sustainable and affordable in the medium to longer term. The financial impact of borrowing is also highlighted through the estimated impact on both the Council Tax level and housing rents together with the overall ration of financing costs to net revenue streams.

### 3.7 Capital Financing Requirement

3.7.1. In order to ensure that borrowing levels are prudent, over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. Net borrowing should not therefore, except in the short term, exceed the CFR for 2008/09 plus the expected changes to the CFR over 2009/10 and 2010/11. The table below confirms that the Council met this requirement at 31 March 2009.

	2008/09 Estimate £'M	2008/09 Actual £'M	ACHIEVED
Net borrowing position	177.641	163.110	<b>YES</b>
Capital Financing Requirement (CFR)	234.369	220.549	<b>YES</b>

3.7.2 The actual levels of net borrowing and CFR are lower than the original indicator reported to Cabinet in April 2008. This is a result of the overall level of funding available to finance capital expenditure being greater than originally anticipated due to additional specific grant. The net borrowing position has also been reduced due to the level of short term investments being maintained at a higher level throughout the year than was budgeted.

### 3.8 Authorised Limit & Operational Boundary

3.8.1 The Authorised Limit is the "Affordable Borrowing Limit" required by Section 35 of the Local Government in Scotland Act 2003. This is the Council's maximum borrowing level and was originally set at £299.400M for 2008/09.

3.8.2 The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or above the Boundary are acceptable subject to the Authorised Limit not being breached. This was originally set at £293.541M for 2008/09.

3.8.3 During 2008/09 the maximum level of actual borrowing did not exceed either of these limits.

### 3.9 Ratio of Financing Costs to Net Revenue Stream

- 3.9.1. This indicator focuses on the extent to which the Council's net revenue budget and Housing rents are used to service the cost of capital debt. The reduction compared to the original general fund indicator is due to lower than forecast interest costs together with an increase in the overall level of revenue from council tax and revenue support grant.

Ratio of financing costs to net revenue stream:	2008/09 Estimate £M	2008/09 Actual £M
General Fund	6.08%	5.69%
HRA	12.58%	11.57%

### 3.10 Incremental Impact on Council Tax and Housing Rents

- 3.10.1 These indicators quantify the impact of capital investment decisions on the level of Council Tax and also the annual housing rents. As there has been no increase in the level of Council Tax over the 2007/08 levels and as the financial consequences of borrowing to the Housing Investment Programme were met from existing resources both indicators are nil.

	2008/09 Estimate £M	2008/09 Actual £M
Incremental Impact of Council Tax	£0.00	£0.00
Incremental Impact on Housing Rents	£0.00	£0.00

### 3.11 Maturity Structure of Fixed Borrowing

- 3.11.1 The amount of fixed rate debt due to mature in 10 years or more is 95.61% which was within the maximum limit set for this indicator in 2008-09 of 100%. The remaining balance of 4.39% is due for periods less than 10 years and is well within the maximum levels set for those periods.

### 3.12 Investments Held by the Council

- 3.12.1 Local authority investment activity is regulated by statute. A revised regulatory framework which has been under consideration by the Scottish Government for some time will provide greater autonomy for local authorities in respect of investment activity and as such more detailed consideration of investment and treasury activity. Consultation has been undertaken by the Government in respect of the revised regulations which when implemented should form a strong basis for the delivery of a robust investment framework for Scottish local authorities. It is expected that these will be available and operational with effect from April 2010.

3.12.2 During 2008/09 the average interest rate achieved for investments made in the year was 5.45% which is comparable to the average 7 day LIBOR (London Inter Bank Offer Rate) offered by the market of 3.807% over the course of the year. It is worth noting that as at 31 March 2009 the LIBOR rate had fallen to 0.69%.

### 3.13 Operational Limits

3.13.1 The Council seeks to comply with best practice in all areas of treasury management. During 2008/09 the following limits were set and adhered to: -

LIMIT	PURPOSE	ACHIEVED
The maximum amount of debt maturing in 1 Year not to exceed 25%	To limit any exposure to high interest rates when renewing maturing debt	YES
No broker should handle more than 75% of annual treasury transactions	To prevent over reliance on one broker and ensure competition within market is utilized	YES
No more than 20% of total investments at any time should be placed with one counterparty.	To limit exposure with any one counterparty	YES

## 4 UPDATE ON 2009/10 TREASURY STRATEGY

The following provides an update on the Council's Treasury Management Strategy for 2009/10.

### 4.1 Economic and Interest Rate Forecast

4.1.1 Following a competitive tendering exercise the Council appointed Arlingclose as its Treasury Management Advisors in May 2009. They provide regular updates on the forecast for economic performance the most recent of which is summarized below.

4.1.2 The global financial system remains fragile and although some confidence has returned national economies have yet to show consistent signs of recovery. The UK economy contracted by 5 ½ % in the year to June 2009. The immediate outlook for growth remains poor given the recession, which is supported by weak real economic data and a continued upward trend in unemployment. The prospect of tighter regulation of the banking sector with tightened capital requirements will curb bank lending activity and is likely to be offset by a reduction in the reserve rate. Given this the prospect is that economic recovery will be slow and protracted.

4.1.3 Official interest rates (Base Rate) of ½ % together with the increased Quantitative Easing by the Bank of England of £175bn should ultimately feed through and stimulate the economy but the effectiveness could be weakened by lower volumes of bank lending. Inflation is falling, albeit slowly. The consumer price index (CPI) could dip below 1% in 2009 and be below the Monetary Policy Committee target of 2% of the 2 year forecast period. The retail price index has been negative since March. The weak position of Sterling remains a risk but is likely to be overshadowed by a slow recovery. The likely make up of the next Parliament will increasingly have an influence on the financial markets with the political agenda rapidly shifting from an avoidance of cuts to a position of inevitability.

- 4.1.4 The projected movement in interest rates for the period up to March 2012 is summarised for information in the following table. It can be seen that the direction of expected travel is upwards and as a result the continued affordability of the Council's capital investment programme will require to be closely monitored.

<b>INTEREST RATE FORECASTS</b>				
	Base Rate	5 Year Gilt	20 Year Gilt	50 Year Gilt
	Estimate	Estimate	Estimate	Estimate
Dec-09	0.50%	2.60%	4.10%	4.00%
Mar-10	0.50%	2.70%	4.25%	4.25%
Sep-10	0.50%	2.90%	4.75%	4.50%
Mar-11	1.50%	3.25%	5.00%	4.75%
Sep-11	3.00%	3.75%	5.00%	4.75%
Mar-12	4.00%	4.25%	5.00%	4.75%

## **4.2 Borrowing Strategy**

- 4.2.1 No borrowing has as yet been undertaken in the current financial year with capital expenditure already incurred having been met from available working capital balances. It is anticipated that advantage will be taken of the low interest rates currently available for short term variable rate loans (up to 5 years) from the Public Works Loan Board (PWLB) to finance current year borrowing. In this regard should interest rates move significantly upwards in future periods the opportunity exists to repay any variable rate debt PWLB loans at any time without penalty and convert them into fixed rate longer term debt thereby providing budget certainty for future years by locking into a predetermined rate of interest.

## **4.3 Investment Strategy**

- 4.3.1 As a result of the current and forecast levels of reserves and cash balances it is expected that the Council will continue to hold significant levels of funds available for short term investment throughout the remainder of this financial year and the next also. These funds will continue to be invested in an attempt to minimise the risk to the capital sum. The primary method of risk control will be through using an approved counter party list to identify institutions and recommended investments limits to ensure an adequate spread of risk is achieved. Greater use of longer terms investments, up to 364 days in the current year and, once the expected Investment regulations are available, for periods in excess of this to maximise the return whilst continuing to limit the counterparty to those supported by the Government Credit guarantee scheme.

## **5 FINANCIAL IMPLICATIONS**

- 5.1 There are no immediate financial implications arising from the report. The costs associated with financing capital expenditure are contained within the revenue budgets for both the General Fund and Housing Revenue Account.

## **6 LEGAL AND POLICY IMPLICATIONS**

- 6.1** The treasury management policies and practices have been complied with during the year.

## **7 RECOMMENDATIONS**

- 7.1** It is recommended that the Cabinet:-
- i) Note the contents of this report.

Alex McPhee  
**Executive Head of Finance and Asset Management**

RB/  
8 October 2009

### **LIST OF BACKGROUND PAPERS**

- 1.** Report to Cabinet 11 February 2009 - Performance Management – Prudential Indicators
- 2.** Report to Cabinet 18 March 2009 – Treasury Strategy 2009/10

Members wishing further information should contact Robin Baker, Financial Controller,  
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