REPORT TO:	**FINANCE AND MANAGEMENT COMMITTEE (SPECIAL – FINAL ACCOUNTS)**	**AGENDA ITEM:**
DATE OF MEETING:	**25th JUNE 2009**	**CATEGORY: DELEGATED**
REPORT FROM:	**DIRECTOR OF CORPORATE SERVICES**	**OPEN**
MEMBERS' CONTACT POINT:	**KEVIN STACKHOUSE (595811)**	**DOC**: u/ks/treasury management/annualreports/2008-2009
SUBJECT:	**TREASURY MANAGEMENT ANNUAL REPORT 2008/09**	**REF:**
WARD (S) AFFECTED:	**ALL**	**TERMS OF REFERENCE: FM 08**

1.0 Recommendations

1.1 That the Treasury Management Annual Report for 2008/09 is considered and approved.

1.2 That the Statement on the Minimum Revenue Provision for 2008/09 is recommended to Council for approval.

2.0 Purpose of Report

2.1 To detail the Council's actual borrowing and lending performance for 2008/09 compared to the approved strategy, including performance against its Prudential Indicators. This is in accordance with the Local Government Act 2003 and associated regulations.

3.0 Executive Summary

3.1 The Council's borrowing and investment strategy for the year required that its cash flow requirements were managed through short-term borrowings and bank deposits. Overall, the Council's cash flow remained positive throughout the year as forecast.

3.2 As financial monitoring reports throughout the year highlighted, the last 12 months have been extraordinary as the fall-out from the credit crunch in 2007/08 caused volatility in financial markets. Coupled with the onset of the economic recession, this lowered base bank interest rates to their lowest level in history, and they currently remain at 0.5%.

3.3 Although the Council had no investments tied up in Icelandic banks or other financial institutions directly affected by market conditions, the overall situation did have an affect on the Council.

3.4 Firstly, a reduction in credit ratings of several financial institutions together with a restructuring of others, limited the choice of deposit takers when set against the Council's lending criteria. This constrained where funds could be deposited during the second half of the year, although this situation had started to ease as the financial year closed.

3.5 Secondly, the low level of interest rates and a lower level of funds available for investment compared to that forecasted, reduced the amount of investment income compared to that budgeted, from £250,000 to approximately £188,000 for the year.

3.6 In undertaking its treasury management functions during the year, the Council managed its activities within its prudential indicators and approved lending policy.

4.0 <u>Detail</u>

Borrowing During 2008/09

4.1 The Council's approved borrowing strategy for 2008/09 was:

- To manage its cash flow requirements through short-term borrowings and bank deposits and that no longer-term borrowing be undertaken in the year.

- That the one remaining Money Market loan of £1m be repaid should the Lender invoke their option to increase the interest rate.

The Council's Cash Flow During 2008/09

4.2 The Council's cash flow on a daily basis can fluctuate depending on the timing of income and expenditure.

4.3 At certain times of the year, the Council may need to borrow to cover shortfalls on a temporary basis, whilst when cash flow is positive any surplus funds are invested on a temporary basis.

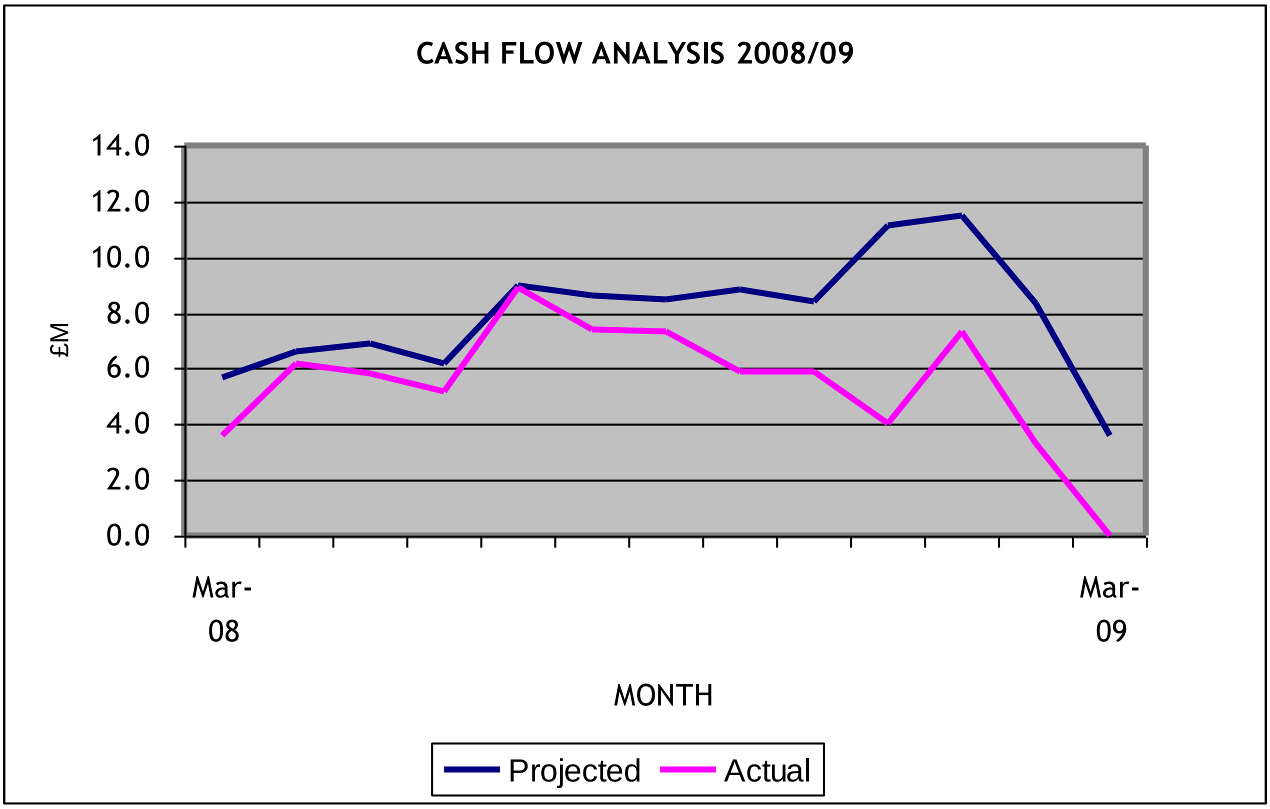
4.4 For several years the Council has not undertaken any form of new long-term borrowing and has not had any Government debt since repaying this in March 2004.

4.5 This was due to substantial capital receipts that the Council had generated from council house and land sales, a proportion of which had been set-aside to repay debt in accordance with accounting regulations.

4.6 These receipts were placed on deposit and earned interest for the Council's revenue funds. In addition, these receipts have effectively been used to finance new capital expenditure in recent years and to meet the Council's shorter-term cash flow requirements when this has been negative.

4.7 The Council continued to benefit from this positive cash flow position throughout 2008/09. This was also due to the amount of revenue and capital reserves/provisions it currently has at its disposal, a large part of which are earmarked for spending in the future.

4.8 The Council's cash flow during 2008/09 with a comparison to that originally projected is shown in the following graph.



4.9 In general, the actual pattern of cash flow followed that projected. However, the amount of funds available was generally lower than estimated, especially during the later part of the year. Indeed, during the last few days of the financial year, the Council had no funds on deposit.

4.10 This was due to expenditure on the capital programme and the release of funds for capital projects being earlier than forecast for cash flow purposes. In addition, the amount of housing benefit paid out quickly accelerated during the final 6 months of the year, and was over £1m more than estimated - this perhaps being a further consequence of the economic recession.

4.11 As the amount of benefit subsidy during the year is reimbursed by the Government based on historic patterns, this money was still outstanding at March 2009 and will not be reimbursed until the final claim is settled in 2009/10.

Interest Rates

4.12 Back in January 2008, the Council's projections assumed interest rates averaging 5% in 2008/09 in accordance with the prevailing market rate and economic predictions guiding its movement during the year. Consequently, the budget for investment income was based on this rate.

4.13 The Bank Base Rate still stood at 5% in April 2008 at the start of the year, and at that time was forecast to rise to combat predicted inflationary pressures in the UK economy.

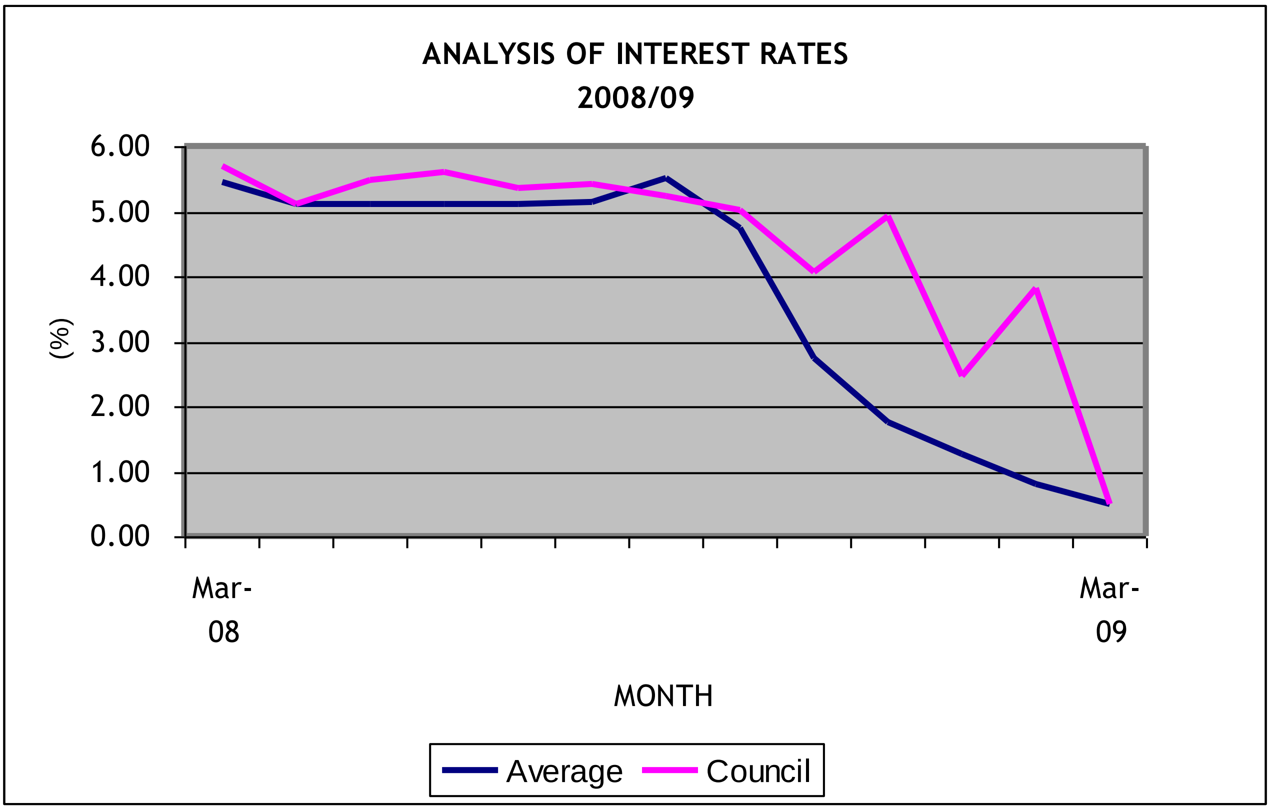
4.14 However, what subsequently occurred to interest rates over the last 9 months was far away from any predictions at that time. In particular, the sharp decline in the global economy and eventually into recession in many parts saw central banks across the world reducing base rates to help stimulate economic activity.

4.15 To start with, the UK base rate remained at 5% during the first 6 months of 2008/09. However, it was reduced 6 times between October 2008 and March 2009 from 5% to 1/2%.

Effect on the Council

4.16 The Council was achieving a return in excess of the budgeted 5% during the first half-year and infact achieved up to 6% on some deposits it made during this period.

4.17 Clearly however, and as previously reported, this average fell sharply over the second half-year, the situation being exacerbated by the tightening of the financial markets and a reduction in funds available for investment. An analysis of the average market rate compared to that achieved by the Council over the year 2008/09 is shown in the following graph.



4.18 The above graph shows that the Council's average rate was generally higher than the market over the year, at 4.38% compared to 3.57% respectively. Clearly however, the average of 4.38% was below the 5% budget.

Temporary Borrowings

4.19 The Council did not require any temporary borrowings during the year. Money is held on deposit for Parish Councils, on which a rate of 1% below the prevailing base rate was paid.

Budgetary Implications

4.20 The level of interest actually received and paid is built into the General Fund Revenue Account (subsequently a proportion of this is recharged into the Housing Revenue Account under a prescribed calculation).

4.21 The actual interest received compared to that included in the approved budget is summarised below.

CASH FLOW INTEREST 2008/09	**ESTIMATE £**	**ACTUAL £**
Overall interest received from money lent/on deposit	250,000	187,950
Less – Interest payments on temporary borrowings	12,500	7,251
Net Interest Received	**237,500**	**180,699**

4.22 The net effect is that overall interest received was lower compared to that estimated by £56,801. This was in line with that previously reported as part of financial monitoring reports during the later part of the financial year.

Other Interest Paid and Received

4.23 In addition, the Council paid and received other interest during the year as set out in the following table.

Summary of Interest Payment and Receipts 2008/09	**Estimate (£)**	**Actual (£)**	**Variance (£)**
Money Market Loan	48,750	48,750	0
Temporary Loans	12,500	7,251	(5,249)
Bank Interest	8,200	1,463	(6,737)
Covenants	143,100	145,583	2,483
Transferred Debt	17,000	22,026	5,026
Interest Received on Deposits	(250,000)	(187,950)	62,050
Other Interest Received	(570)	(1,626)	(1,056)
Interest Recharged to the HRA	(99,000)	(41,924)	57,076
Net Interest (Received)/Payable	**(120,020)**	**(6,427)**	**113,593**

Money Market Debt

4.24 The only long-term debt still remaining is one money market loan for £1m. As the above table shows, this costs £48,750 per year in interest charges at a fixed rate of 4.875%. It is due to mature in 2032.

4.25 Potentially, there is a break clause. The lender has the option of reviewing the interest rate at any time and increasing it if they so wish. However, the Council then has the option of rejecting this and can instead choose to repay without incurring any penalty.

4.26 In setting the borrowing strategy for 2008/09, it was noted that it was not cost effective to prematurely repay the loan due to the penalty payment involved. However, it was also resolved that should the lender exercise their option to increase the interest rate, then the loan should be repaid at that time from money set-aside to do so.

4.27 The lender did not invoke their option during the year and the situation will be kept under review. The same strategy regarding this loan was adopted as part of the treasury management strategy for 2009/10.

Investments 2008/09

4.28 The Council does not have any long-term investments, but the Council is required to maintain an investment strategy covering short-term investments such as the deposit of surplus funds.

4.29 The overall strategy in the year was to effectively invest surplus funds to meet cash flow requirements within the year. In addition, there was no proposal to enter into longer term and externally managed funds.

4.30 The Council invests surplus funds in accordance with an approved policy and associated lending list. This is summarised in the following table.

Institution	**Limit**
Specified Investments	
• UK Debt Management Office (DMO)	£10m
• Local, Police, Fire and Parish Authorities	£5m
• Other Bodies with a High Credit Rating of F1+/AA-	£7.5m
Non-Specified Investments	
• F1/AA Rated Bodies – First Call	£2m
• F1/A Rated Bodies – Second Call	£1m
• F2/A Rated Bodies – Third Call	£0.25m

Definition of Credit Ratings

4.31 The long-term rating is based on an investment grade categorised by “Fitch” on the following scale.

- AAA: the best quality companies, reliable and stable
- AA: quality companies, a bit higher risk than AAA
- A: economic situation can affect finance
- BBB: medium class companies which are satisfactory at the moment.

4.32 Intermediate modifiers are also used for each category between AAA and BBB (i.e. AA+, AA, AA-, A+, A, A-, etc.).

4.33 Short-term credit ratings indicate the potential level of default within a 12-month period, based on the following scale.

- F1+: best quality grade, indicating exceptionally strong capacity to meet financial commitments.
- F1: best grade, indicating strong capacity to financial commitments.
- F2: good quality grade with satisfactory capacity to financial commitments.

4.34 The scale then falls from F3 to B, then C and finally down to D, which indicates the institution is likely to, or as failed to meet its financial commitments.

General Policy

4.35 As approved, priority is given to specified investments in any investment decision. The length of investment is made in accordance with overall cash flow requirements.

4.36 The Council’s policy is to seek investments with those institutions graded at least AA and F1+.

4.36 A substantial amount of available funds are lodged with the Council’s own bank, together other major UK banks and building societies whose credit ratings fall within the approved policy.

4.37 All deposits made were in accordance with the approved lending list and were all Specified Investments. The Council had no investments tied up in Icelandic banks or other financial institutions directly affected by the volatility in the money markets.

Performance Indicators

4.38 The main indicator is for the return on short-term investments to average over the year, **the local authority 7-Day Rate,** a standard measure of performance. The Council’s performance for 2008/09 (with a comparison to recent years) is shown in the following table.

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
7-Day Rate (target)	3.51%	4.47%	4.44%	4.82%	5.61%	3.57%
Actual Rate	3.55%	4.63%	4.50%	4.86%	5.81%	4.38%

Prudential Indicators

4.39 Under the Code of Practice for Capital Finance, the Council must set and regularly monitor Prudential Indicators. These indicators are designed to measure and place controls over the level of borrowing and capital financing during the year.

4.40 They are set following the annual budget round where the Section 151 (Chief Finance) Officer is required to provide an assessment of these indicators and the implications for the Council's spending plans and overall financial position.

4.41 The prudential system provides the flexibility for these indicators to be changed depending on local circumstances. It is the responsibility of the Section 151 Officer to advice the Council accordingly.

4.42 The actual indicators for 2008/09 with a comparison to those set, are detailed in **Appendix 1.** There were no major variations to the approved indicators during the year and the Council operated within its capital budgets and limits for external borrowing at all times.

Minimum Revenue Provision (MRP) - Background

4.43 Local authorities are required each year to set-aside some of their revenues as a provision to repay any borrowings or other credit (shorthand this is technically called "debt"). This set-aside is known as MRP and is a charge on the Council's General Fund.

4.44 This requirement has existed for many years and is designed to ensure that authorities, prudently, make provision to meet their credit liabilities into the future. With effect from 2007/08, the regulations governing this were amended.

4.45 This was to ensure that authorities continue to make a sufficient and prudent provision in their accounts, in particular where they have made any unsupported borrowing under the Prudential System.

4.46 Under the previous regulations, the calculation of MRP was effectively a set formula, although there was provision to increase this amount if an authority so wished. Regulations now effectively force authorities to undertake their own calculation under 1 of 4 options, depending on local circumstances.

4.47 It is the responsibility of the Section 151 Officer to advise on the treatment of MRP and to recommend a suitable policy for adoption. Consequently, authorities are also required to prepare an annual statement on making a MRP.

The Calculation

4.48 MRP traditionally had been calculated (at a rate of 4%) based on an assumed historical level of debt. This assumed level is in effect set by central government in their annual financial settlement. It is based on previous "permissions to borrow."

4.49 These permissions are backed by support towards servicing the associated debt (including MRP) through revenue support grant.

4.50 It is important to note however, that over time, the assumed level will not in practice, usually match the actual level of debt outstanding at an authority.

4.51 This is because actual repayments and new borrowing will have been undertaken over different time scales and at varying interest rates to suit an authority's borrowing requirement, their cash flow and prevailing money market conditions.

4.52 In addition, debt restructures will also have created a difference between the assumed level and actual debt outstanding at any one time.

The 4 Options

4.53 The calculation is now designed to ensure that a "prudent" provision is made for debt repayment. The 4 options are as follows:

- **Option 1** - For debt that is supported by the Government through the grant system, authorities may continue to use the formula in current regulations (4%), since revenue support grant is calculated on that basis. Technically however, this option has in fact been revoked, but has been maintained temporarily as a transitional measure for capital expenditure incurred before 1st April 2008.

- **Option 2** – A simplified method of option 1 that reflects supported debt based on an authority's capital financing requirement. This method should have been in place since 2004 when the Prudential System was introduced.

- **Option 3** – The method to use for new borrowing under the Prudential System for which no Government support is given, MRP being based on the life of the asset being purchased.

- **Option 4** – As above, but MRP relates to the depreciation charge on the asset purchased.

Effect on South Derbyshire

4.54 The Council is operating under Option 2. Technically, the Council has been debt free under these regulations since 2004 (having repaid its Government borrowings). In addition, it has not entered into any new borrowing in recent years to finance its capital expenditure.

Council Statement on MRP

4.55 The Council still has an assumed level of debt (or capital financing requirement) that is being subsidised through grant. Therefore, given no actual debt outstanding together with no unsupported borrowing, it is recommended that "prudence" be best achieved by continuing to provide a MRP under **Option 2**.

4.56 It is recommended that this policy be endorsed for 2008/09 and adopted for 2009/10. It will be kept under review depending on the Council's future capital expenditure and financing requirements.

4.57 Any proposed changes will be reported as necessary to this Committee for consideration and recommendation to Council. The impact on the MRP will be considered in any decision to enter into any borrowing under the Prudential System.

5.0 Financial Implications

5.1 As detailed in the report. The changes to the MRP and the proposed Statement, has no additional financial implications for the Council at this stage.

6.0 Corporate Implications

6.1 None directly.

7.0 Community Implications

7.1 None directly.

8.0 Background Papers

8.1 Local Government Act 2003 and associated Statutory Instruments detailing regulations under the Local Authorities (Capital Finance and Accounting England Regulations) of 2003, 2006 and 2008.

APPENDIX 1 - PRUDENTIAL INDICATORS 2008/09

	Estimate £'000	Actual £'000
CAPITAL EXPENDITURE AND FINANCING		
Capital Expenditure – General Fund		
Supported spend	4,441	3,781
Unsupported spend	0	0
Total spend - General Fund	**4,441**	**3,780**
Financed by:		
Capital receipts	1,346	605
Capital grants and contributions	2,944	3,097
Capital reserves	101	30
Revenue	50	49
Total financing - General Fund	**4,441**	**3,780**
Net financing need - General Fund	**0**	**0**
Capital Expenditure – Housing Revenue Account		
Supported spend	2,867	2,910
Unsupported spend	0	0
Total spend - HRA	**2,867**	**2,910**
Financed by:		
Capital receipts	409	340
Capital grants and contributions	1,875	1,898
Capital reserves	533	622
Revenue	50	50
Total financing - HRA	**2,867**	**2,910**
Net financing need - HRA	**0**	**0**
Capital Expenditure – Total		
Supported spend	7,308	6,691
Unsupported spend	0	0
Total spend	**7,308**	**6,691**
Capital Expenditure – Financing		
Capital receipts	1,755	945
Capital grants and contributions	4,819	4,995
Capital reserves	634	652
Revenue	100	99
Total financing	**7,308**	**6,691**
Net financing need	**0**	**0**

THE CAPITAL FINANCING REQUIREMENT

General Fund

Opening Balance	7,745	7,745
Net financing need	0	0
Less Minimum and Voluntary Revenue Provisions	-310	-310
Less other financing movements	0	0
CFR Closing balance	7,435	7,435
Net movement in CFR	-310	-310

Housing Revenue Account

Opening Balance	5,513	5,513
Net financing need	0	0
Voluntary Revenue Provision	0	0
Less other financing movements	-18	-18
CFR Closing balance	5,495	5,495
Net movement in CFR	-18	-18

The Capital Financing Requirement - Total

Opening Balance	13,258	13,258
Net financing need	0	0
Minimum and Voluntary Revenue Provisions	-310	-310
Less other financing movements	-18	-18
CFR Closing balance	12,930	12,930
Net movement in CFR	-328	-328

EXTERNAL DEBT & OTHER LONG TERM LIABILITIES

Opening Balance 1 April 2008	1,000	1,000
Maturing Debt	0	0
Borrowing - Maturing Debt	0	0
Borrowing - Change in CFR	0	0
Total Debt 31 March 2009	1,000	1,000
Net movement in debt	0	0
Other long term liabilities	1,737	1,737

AUTHORISED LIMIT AND OPERATIONAL BOUNDARY

Authorised Limit	24,550	24,550
Operational Boundary	12,950	12,950

INVESTMENTS

Opening Balance 1 April 2008	3,660	3,660
Cash flow movements	2,541	-2,242
Movement in reserves /balances	-5,701	-1,418
Total Investments 31 March 2009	500	0
Net movement in investments	3,160	3,660