Item 4

REPORT TO CABINET

4TH DECEMBER 2008

REPORT OF DIRECTOR OF RESOURCES

INTERIM REVIEW OF TREASURY MANAGEMENT 2008-09

1.0 SUMMARY

1.1 The purpose of this report is to provide a review of the Council's Treasury Management Activities during the 2008-09 year to date. The treasury management strategy is an integral part of the financial planning process that underpins the financial position of the Council.

1.2 In light of recent turbulence in the financial and banking sector and the current uncertainty in the market, it is considered appropriate to review the Council's financial position and treasury management practices to identify any impact on the Council and its approach to treasury activities to minimise its risk exposure.

1.3 This report will cover the following:

- economic conditions and the 'credit crunch';
- the Council's investment strategy and practices;
- review of the investment and borrowing activities for the period;
- summary of the Council's net treasury position;
- monitoring of the Council's prudential indicators.

2.0 RECOMMENDATIONS

2.1 It is recommended that Cabinet note:

a) the treasury management activities undertaken for the period including compliance with the approved treasury management strategy 2008-09;

b) the performance of the Council's investments for the reported period;

c) the prudent approach taken by the Council in managing its investment portfolio and choosing to invest in UK/Irish financial institutions only and that this be endorsed ;

d) the take up of additional borrowing of £4.999m during the period to take the Council's borrowing to the level of its 'attributable housing debt'

3.0 TREASURY MANAGEMENT STRATEGY 2008-09

3.1 Economic Conditions and the 'Credit Crunch'

3.1.1 The globalization of financial markets has meant that an essentially localized US sub-prime problem has been sold on throughout the world financial markets, impacting directly on the quality of banking balance sheets. The uncertainty in assessing the impact of these 'toxic' assets on financial institutions' balance sheets meant that there has been an unwillingness and inability for institutions to lend to each other.

3.1.2 In October 2008, the collapse of the Icelandic banking system left many local authorities with exposure to these counterparties at risk of a banking default. At the present time, it is not known whether this money will be repaid in full, if at all. The associated banking problems have seen local authority investment strategies come increasingly under the spotlight

3.1.3 According to the most recent figures published by the Local Government Association, 123 councils have deposited around £920 million in the Icelandic banks. In addition, public bodies – such as Police Authorities and Transport Authorities – have a further £100 million in Icelandic banks while charities are believed to have £120 million in such accounts. Some universities and NHS Trusts are also affected and the Audit Commission, which monitors local government spending, deposited £10 million itself.

3.1.4 **Sedgefield Borough Council does not have (and never has had) any deposits held with Icelandic banks**, and therefore there is no risk exposure to the Council as a result of the recent collapse of the Icelandic banking system**.** As will be explained later in this report, officers of the Council have always given priority to maintaining the security of its investments. Although our investment strategy allows us to place resources in a multititude of highly rated financial institutions, including those institutions that are now experiencing liquidity problems, such as the Icelandic banks, officers of the Council have made a conscious decision to not necessarily invest in such institutions, despite the historically high credit ratings they may have received just before the liquidity problems became known.

3.2 Investment Strategy and Practices

3.2.1 The Council has adopted a comprehensive professional Local Code of Practice covering the whole of its treasury function in the form of Treasury Management Practices (TMPs), which were last reviewed and adopted by Council on 30th September 2005. With the support of its appointed specialist treasury management advisors [Butlers], the Council reviews and agrees an annual Treasury Management Strategy governing its treasury activities for the year to ensure it is in line with Government guidance and best practice. The most recent update to the Strategy was formally adopted by Council on 29th February 2008.

3.2.2 The Strategy effectively sets out the detailed ground rules for investment (and borrowing) decisions. It is based around the primary principles of endeavouring to maintain the security of investments, although the yield or return on the investments is also a key consideration. In the current year the interest earned on our investments is budgeted to produce an income for the Council of about **£1.3m**, which helps keep council tax bills down.

3.2.3 The Council's Local Code of Practice for Treasury Management Practices (TMPs) provides guidelines on how credit and counterparty risk is managed (Section 1.5). Credit and counterparty risk is defined as *'the risk of failure by a third party to meet its contractual obligations to the Council under an investment…as a result of the third party's diminished credit worthiness, and the resulting detrimental impact on the Council's capital or current (revenue) resources.'* The TMP also provided details of how the Council creates and manages its counterparty lists and associated financial limits.

3.2.4 This includes the use of published ratings to assess the creditworthiness of banks and building societies. The financial industry uses credit ratings provided by three rating agencies (Fitch, Moody's and Standard and Poors) to assess the credit quality of these institutions. These credit ratings are updated regularly by the companies publishing them. The criteria used to select which financial institutions are appropriate to receive investments from the Council are set out in the Treasury Management Strategy and in relation to banks and building societies are as follows:

- Banks – the Council will use banks which have at least the following Fitch or equivalent ratings (see **Appendix A** for guidance on ratings):
  - *i.* Short Term – *F1*
  - *ii.* Long Term – *A*
  - *iii.* Individual / Financial Strength – *C* (Fitch / Moody's only)
  - *iv.* Support – *3* (Fitch only)
- Building Societies – the Council will use all Building Societies who meet the criteria outlined for banks above and those unrated Societies with assets greater than £200 million.

3.2.5 As briefly mentioned in paragraph 3.1.4, although the Council's framework for investment allows it to place funds in a large range of institutions, the Council's current practice has been to invest in financial institutions in the UK/Ireland only and predominantly these have been with building societies (around 44 in total) with asset sizes in excess of £200m. This has proven to be a prudent and effective approach to managing counterparty risk, whilst at the same time has generated a good rate of return on the Council's investments. Although the Council makes use of credit ratings and also considers the advice provided by its treasury consultants, ultimately officers of the Council must make their own decisions on investments and borrowing with the primary aim of securing the Council's investments as opposed to maximising returns.

3.2.6 Details of the Council's investment portfolio as at 31st October 2008 are provided in **Appendix B**. In summary, this shows that investments of **£25.26m** were held at that date of which **£9.5m** are long term investments held with banks, **£14.25m** in fixed investments with building societies and temporary investments of **£1.51m** held in call accounts with banks. Included in long term investments is one deposit for £2m that the Council placed in a Canadian bank (Toronto-Dominion) around 3 years ago. This bank has the highest credit rating possible (F1+ or 'exceptionally strong credit quality') and there is considered to be no risk of default on repayment of this deposit.

3.2.7 It should be noted that credit ratings are a statement of opinion, **not a guarantee**. Therefore, even with the highest rated organisations, it is important

that suitable parameters are put in place to manage the risk of counterparty default.

3.2.8 During the recent period of heightened uncertainty, particularly at the time of the Icelandic banking crisis, further tighter measures were taken by officers to protect the Council's financial position and minimise its exposure to counterparty risk, and these additional measures involved:

- Avoidance of hitting limits for maximum sums invested with an institution and instead spreading investments across a multitude of institutions;
- Restricting investments to the top 20 building societies in terms of asset size (as opposed to all 44 available);
- Ensuring that credit ratings and downgradings of institutions were examined closely and no further funds invested with any institution receiving a downgrading;
- Involving both the Head of Financial Services and Director of Resources in discussions surrounding investment decisions.

3.3 Review of Investment Activities and Performance

3.3.1 Officers assess the Council's cash flows on a daily basis, taking into account detailed forecasts of funds needed throughout the year, and invest surplus funds in accordance with approved Treasury Management Practices (TMPs) and only to authorised counterparties. Excess funds that are held temporarily for only a few days, for cash flow purposes, are invested in three specific accounts - the Anglo Irish Bank, Bank of Scotland or the Co-operative Bank – depending on which of these is offering the best rate of interest at the time.

3.3.2 The primary aim is to ensure the security of the Council's investments – not necessarily to maximise the return – and a prudent approach is taken at all times. The objective is to optimise investment income by achieving a level of return greater than that which would have accrued if all surplus cash was invested at interest rates applicable to the average seven day investment rate, as quoted by the Council's nominated brokers.

3.3.3 The average seven-day compounded London Inter Bank Bid rate (LIBID) to the period ending October 2008 was **5.08%**.

3.3.4 The actual return achieved by this Council so far during the current financial year was **5.75%,** which is **0.67%** higher than the above comparator. The target set in the treasury strategy for 2008-09 was to achieve 0.05% above the LIBID rate, which means that officers have so far been successful in exceeding the standard benchmark for investments and also exceeding its own internal target. In financial terms this equates to an additional **£89,260** interest earned during the year.

3.3.5 The Council has appointed three approved money brokers to act on its behalf. These brokers are responsible for securing the best interest rates available from the market for the investment of surplus loans. Investments are limited to the approved counterparties' list and control totals govern the maximum value of investments with each of these. In addition, the Council also has direct dealings with three instant access deposit accounts (Anglo-Irish Bank, Alliance

and Leicester and Co-operative Bank), which are used to invest smaller sums frequently on a temporary basis.

3.3.6 The following table identifies the total number of investments made in 2008-09 to date, showing the number and total value of deals per broker and by deposit account type:

	Year to Date	
Investment Type	**No. of Deals**	**Value of Deals (£ m)**
Fixed Investments via Brokers		
Tullet Prebon (UK) Ltd	10	6.250
Martin Brokers (UK) plc	6	4.000
Tradition (UK) Ltd	11	9.500
Direct Dealings	20	27.250
	47	**47.000**
Instant Access Deposit Accounts		
Anglo Irish Bank	71	25.190
Co-op Bank	11	10.160
Alliance & Leicester	1	0.520
	83	**35.870**
Grand Total	**130**	**82.870**

3.3.7 As the table shows, **130** investments have been made and total funds invested in institutions equate to just under **£83m** for the 7 month period. The Council has been successful in minimizing its exposure to counterparty risks and maintaining the security of the above investments through prudent and effective management, control and decision making surrounding its investment activities.

3.4 Review of Borrowing Activities

3.4.1 An analysis of all long term loan transactions (both Public Works Loan Board [PWLB] and non-PWLB) during 2008-09 is as follows:-

Type of Institution	Debt at 1.4.08 £m	New Borrowing £m	Normal Repayments £m	Premature Repayments £m	Debt at 31.10.08 £m
PWLB	18.284	4.999	0.019	-	23.264
Other	0.316	-	0.006	-	0.310
Total	**18.600**	**4.999**	**0.025**	**0.000**	**23.574**

3.4.2 The main movement in the debt position relates to the taking out of a 1 year loan of £4.999m on 13th October at a rate of 3.21%. This loan was taken out to maximise the Council's treasury position in light of the forthcoming transfer of its housing stock. As part of the stock transfer process, any debt borrowed from the PWLB associated with the Council's housing revenue account would be repaid by the Government. According to the Housing Subsidy Determination, the attributable debt for housing equates to just over **£23m**. The Council's actual debt stood at only **£18.6m** at the beginning of the year and therefore additional borrowing was recently taken out to ensure that the correct amount of debt could be repaid on transfer. The Council would effectively become 'debt free' after the stock transfer with the exception of around £310,000 borrowed from Durham County Council Pension Fund.

3.5 Net Treasury Position

3.5.1 The table below summarises the Council's net treasury position as at the end of October 2008, compared to the position at the end of March 2008.

	31 Mar 08 £m	31 Oct 08 £m	Increase / (Decrease £m
Loans			
Public Works Loan Board	18.284	23.264	4.980
Other Long term Loans	0.316	0.310	(0.006)
Total Loans	**18.600**	**23.574**	**4.974**
Investments			
Temporary Investments	12.270	15.760	3.490
Long Term Investments	9.500	9.500	-
Total Investments	**21.770**	**25.260**	**3.490**
Net Position	**(3.170)**	**(1.686)**	**1.484**

3.5.2 The Council's net borrowing position at the end of October was (**£1.686m)**, a decrease £1.484m over the position as at 31 March 2008. Analysis of the movement in the net treasury position has been explained in earlier paragraphs regarding investment and borrowing activity during the year. It should be noted that the Council's investments will be expected to fall during the year as resources are used to fund the Council's £26m capital programme, without resorting to borrowing.

3.6 Prudential Limits

3.6.1 Council adopted and approved its prudential indicators in February 2008 as part of the 2008-09 Treasury Management Strategy. A summary of the key controls surrounding the treasury and capital finance position is shown below alongside the actual position to the end of October 2008:

	Key Prudential Indicators	*2008-09 Estimate £'000*	*Oct 2008 Position £'000*
	Gross Borrowing	18,556	23,574
	Investments	(23,000)	(25,260)
(1)	**Net Borrowing**	**(4,444)**	**(1,686)**
(2)	**Capital Financing Requirement**	**18,683**	**13,834**
(3)	**Authorised Limit**	**30,000**	**23,000**
(4)	**Operational Boundary**	**25,000**	**23,574**

- The **Capital Financing Requirement** (CFR) in 2) above shows the Council's underlying need to borrow for a capital purpose. Under normal circumstances, actual borrowing should be broadly in line with the CFR. The current position shows that the CFR of £13.8m is below gross borrowing of £23.6m – a £10m variance, which is explained by two factors. Firstly, £5m of unapplied capital receipts were used in 2007-08 to voluntarily reduce CFR, but these will be taken into account in financing the 2008-09 capital programme and will return the CFR to its normal level (excluding impact of stock transfer, around £18m). Secondly, as explained in paragraph 3.4.2, additional borrowing of around £5m was taken during October to facilitate repayment of housing debt on stock transfer.

- The **Authorised Limit** in 3) above is the statutory 'Affordable Borrowing Limit' required by Section 3 of the Local Government Act 2003. This is the maximum amount that the Council can borrow and the limit of £30m cannot be exceeded.
- The **Operational Boundary** in 4) above is the expected borrowing position of the Council during the year, and periods where the actual position is either below or over the Boundary **is acceptable** subject to the Authorised Limit not being breached. This is **not a limit** and actual borrowing can vary above or below this level during the year. This indicator has been increased to £25m by Council at its meeting on 21st November 2008 (from an initial level of £22m).

3.7 Summary

3.7.1 In conclusion, the borrowing and investment activities undertaken during the period fully comply with the Council's agreed Treasury Management Strategy. All investments were made in approved instruments, with financial institutions on the Council's approved list and in accordance with the Council's investment guidelines.

3.7.2 Given the current uncertain and unprecedented financial climate, officers will continue to rigorously review its investment portfolio in conjunction with its Treasury Management Consultants [Butlers] to minimise risk exposure.

4.0 CORPORATE POLICY CONSIDERATIONS

4.1 This report does not contain proposals that would require any changes to the Council's agreed policy framework and corporate objectives.

5.0 RESOURCE IMPLICATIONS

5.1 There are no further resource implications arising from this report.

6.0 CONSULTATIONS

6.1 Comprehensive consultation has previously been held during the construction of the 2008-09 Budget Framework. This report does not contain any proposals or recommendations requiring further consultation.

7.0 OTHER MATERIAL CONSIDERATIONS

7.1 ***Links to Corporate Objectives/Values***

The Council's Corporate Objectives and Values have guided the preparation of the 2008-09 Budget Framework throughout. Resource availability has been fully re-assessed and directed to assist in achieving the Council's key priorities as set out in the Corporate Plan.

7.2 ***Risk Management***

7.2.1 The Authority has adopted the CIPFA Treasury Management Code of Practice, part of which requires the effective management of control of risk as a prime objective of its treasury management activities, policies and practices. In compliance with the Code, the Authority in its Treasury Management Practices document has identified the main areas of risk and the measures adopted to

control these risks. Security of funds, rather than rate of return achieved, is of paramount importance.

7.2.2 The main risks faced by the Authority with regard to investments include liquidity, interest rate exposure, credit and counterparty, and market risk. The main measures taken to control the identified risks include the establishment of credit limits, counterparty restrictions, decision-making matrix, and investment guidelines. The measures taken to control the main risks faced with regard to borrowing include borrowing limits and variable rate exposure limits.

7.3 ***Health and Safety***
No additional implications have been identified.

7.4 ***Equality and Diversity***
No material considerations have been identified.

7.5 ***Legal and Constitutional***
The Budget Framework and Treasury Management Strategy have been prepared in accordance with the Council's Constitution and full account has been taken of new statutory requirements. No other legal or constitutional implications have been identified.

8.0 OVERVIEW AND SCRUTINY IMPLICATIONS

8.1 Consultation and engagement with Overview and Scrutiny Committees has previously been held in development and review of the 2008-09 Budget Framework. There are no new matters to be considered.

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Ward(s): **Not Ward Specific**

Background Papers:
1. **Treasury Management Strategy 2008-09 – Report to Council 29th February 2008**
2. **Local Code of Treasury Management Practices – Report to Council 30th September 2005**
3. **LSVT to Sedgefield Borough Homes – Report to Council 21st November 2008**

EXAMINATION BY STATUTORY OFFICERS

	YES	NOT APPLICABLE
1. The report has been examined by the Council's Head of the Paid Service or his representative	✓	
2. The content has been examined by the Council's S151 Officer or his representative.	✓	
3. The content has been examined by the Council's Monitoring Officer or his representative	✓	
4. The report has been approved by Management Team	✓	

APPENDIX A

CREDIT RATING CRITERIA GUIDANCE

Rating	Minimum requirement*	Comment
Short-term *(capacity for timely payment of financial commitments)*	F1	*Strongest capacity, may also be F1+ denoting exceptionally strong credit feature*
Long-term *(capacity for timely payment of financial commitments)*	Category A	*High credit quality with low expectation of credit risk.* *The highest rating under this category is AAA*
Individual *(Assessment of the individual organisation ignoring any potential external support)*	C	*Adequate bank* *Highest rating is A*
Financial Strength *(Assessment of likelihood of organisation requiring assistance from third parties)*	C	*Adequate bank* *Highest rating is A*
Support *(Assessment of level of potential support either from sovereign state or group etc.)*	3	*Moderate probability of support* *Highest rating is a 1*

* - Fitch Rating or equivalent from other leading rating agencies (Moody's and Standard & Poor's)

SEDGEFIELD BC – SUMMARY OF INVESTMENTS AS AT 31/10/08						
Date of Loan	**Borrower**	**Value (£)**	**% Total**	**Interest Rate**	**Loan Period (Days)**	**Date Repaid**
		BANKING SECTOR				
08/06/05	**HSBC Bank PLC**	**5,000,000**	**19.79%**	5.51%	6Year 6mth.Callable Deposit	13/06/11
04/10/05	**Royal Bank of Scotland**	**2,500,000**	**9.90%**	5.30%	5Year 6mth.Callable Deposit	04/10/10
21/10/05	**Toronto Dominion Bank**	**2,000,000**	**7.92%**	5.38%	5Year 6mth.Callable Deposit	21/10/10
	LONG TERM INVESTMENTS-BANKING SECTOR	**9,500,000**	**37.61%**			
08/07/08	**Bank of Scotland**	**500,000**	**1.98%**	6.30%	184	08/01/09
29/08/08	Anglo Irish Bank	500,000		5.94%	145	30/01/09
N/a	Anglo Irish Bank Star Call a/c	510,000		4.55%	N/a	N/a
	Sub Total – Anglo Irish Bank	**1,010,000**	**4.00%**			
	SHORT TERM INVESTMENTS-BANKING SECTOR	**1,510,000**	**5.98%**			
	SUB TOTAL – BANKING SECTOR	**11,010,000**	**43.59%**			
		BUILDING SOCIETIES				
31/07/08	Tipton & Colesley	1,000,000		5.90%	106	14/11/08
05/09/08	Tipon & Colesley	500,000		5.93%	160	12/02/09
	Sub Total – Tipton & Colesley	**1,500,000**	**5.94%**			
13/10/08	**Skipton**	**1,500,000**	**5.94%**	6.30%	92	13/01/09
13/10/08	**Chelsea**	**1,500,000**	**5.94%**	6.40%	151	13/03/09
12/06/08	Vernon	750,000		6.25%	186	15/12/08
24/06/08	Vernon	500,000		6.30%	189	30/12/08
	Sub Total – Vernon	**1,250,000**	**4.94%**			
12/09/08	Manchester	750,000		5.81%	97	18/12/08
15/09/08	Manchester	500,000		5.82%	91	15/12/08
	Sub Total – Manchester	**1,250,000**	**4.94%**			
19/08/08	**Furness**	**1,000,000**	**3.96%**	5.91%	133	30/12/08
24/06/08	**Darlington**	**1,000,000**	**3.96%**	6.45%	268	19/03/09
13/10/08	**Newcastle**	**1,000,000**	**3.96%**	6.50%	273	13/07/09
13/10/08	**Norwich & Peterborough**	**1,000,000**	**3.96%**	6.40%	184	15/04/09
17/10/08	**Stroud & Swindon**	**750,000**	**2.97%**	6.40%	122	16/02/09
01/07/08	**National Counties**	**500,000**	**1.98%**	6.22%	197	14/01/09
21/08/08	**EBS**	**500,000**	**1.98%**	5.95%	154	22/01/09
10/06/08	**Loughborough**	**500,000**	**1.98%**	6.27%	188	15/12/08
28/10/08	**Kent Reliance**	**500,000**	1.98%	6.32%	122	27/02/09
06/12/07	**Hinckley and Rugby**	**500,000**	1.98%	6.25%	364	04/12/08
	SUB TOTAL – BUILDING SOCIETIES	**14,250,000**	**56.41%**			
	GRAND TOTAL	**25,260,000**				