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OXFORD CITY COUNCIL

Report of: **Head of Finance**

To: **City Executive Board & Council**

Date: **3rd September 2008, 6th October 2008** **Item No:**

Title of Report: **Treasury Management Annual Report 2007/08**

<u>Summary and Recommendations</u>

Purpose of report: The annual treasury report is a requirement of the Council's reporting procedures. It covers the treasury activity for 2007/08, and the actual Prudential Indicators for 2007/08.

Key decision: No

Portfolio Holder: Councillor Ed Turner

Report Approved by:
Penny Gardner – Head of Finance
Councillor Ed Turner
Lindsay Cane - Legal

Policy Framework: None

Recommendation(s): The City Executive Board is asked to recommend Council to:
1) Approve the actual 2007/08 prudential indicators within the report
2) Note the treasury management annual report for 2007/08
3) Recommend to Council the approval of the proposed changes to the counterparty list as stated within the report

Executive Summary

1. The Council had outstanding debt of £7,746,811 as at 31st March 2008, this is all held with the PWLB at a fixed interest rate. The total interest paid on this debt in 2007/08 was £1,025,200.

2. The Council also had investments of £31,100,000 as at 31st March 2008, this was a selection of fixed term investments over varying periods. These periods ranged from overnight to 364 days. The total interest earned on these investments was £2,445,400.

3. In relation to investments the primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:
    - It has sufficient liquidity in its investments
    - It maintains a policy covering both the categories of investment types and criteria for choosing investment counterparties

4. In relation to the Council's debt strategy the Heads of Finance will take the most appropriate form of borrowing depending on the prevailing interest rates at the time.

5. The Council adhered to its Treasury Strategy for both Debt management and Investment management for 2007/08.

6. The Prudential Indicators that the Council produces are used to determine the limits that the Council must operate within when carrying out its Treasury Management activities.

7. The Council has a statutory requirement to produce, monitor and report its Prudential Indicators, this is in line with the Prudential Code. The Prudential Indicators detailed in the body of this report are looking back at the results for 2007/08, and are designed to show the Council's position for each individual indicator, with an explanation of its relevance.

8. Key objectives of the Prudential Code are to ensure that the capital investment plans of local authorities are affordable, prudent and sustainable.

9. The Prudential system provides a flexible framework approach within which capital assets can be procured, managed, maintained and developed. At a strategic level it allows authorities to make their own decisions about the balance to be struck between revenue intensive or capital intensive methods of procuring services. It also allows capital investment to proceed where the authority can fund it within prudent

and affordable limits. As a consequence these arrangements permit 'spend to save' schemes to proceed where they are not only affordable but also prudent and sustainable. In practice this means that local authorities can borrow to fund capital schemes making repayments from the resulting revenue savings.

Background

10. The annual treasury report is a requirement of the Council's reporting procedures. It covers the treasury activity for 2007/08, and the actual Prudential Indicators for 2007/08.

11. The report meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

12. This report is a backward look at the treasury activities for 2007/08, and looks at how the Council has performed throughout the year. The strategy for the current year, 2008/09, was approved at Council in February 2008, and the strategy for 2009/10 will go through the approval process alongside the budget for 2009/10, and further reports will report the activities of each year within six months of the year end. This report summarises:
    - The capital activity for the year, and how this was financed;
    - The impact on the Council's indebtedness for capital purposes;
    - The Council's overall treasury position;
    - The reporting of the required prudential indicators;
    - A summary of interest rate movements in the year;
    - Debt activity;
    - Investment activity;

The Council's Capital Expenditure and Financing 2006/07

13. The Council undertakes capital expenditure on long-term assets. These activities may either be:
    - Financed immediately through capital receipts, capital grants or other external funding; or
    - If insufficient financing is available the expenditure will give rise to a borrowing need.

14. Part of the Council's treasury activities is to address this 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 flow, its previous borrowing activities and the investment of surplus funds. These activities are structured to manage risk foremost, and then optimise performance.

15. The actual capital expenditure forms one of the required prudential indicators. The table below show this and how it has been financed.

£000's	2006/07 Actual	2007/08 Estimate	2007/08 Acutal
Non- HRA capital expenditure	7,402.1	9,108.8	7,484.00
HRA capital expenditure	10,890.2	11,300.0	12,490.00
Total capital expenditure	**18,292.3**	**20,408.8**	**19,974.00**
Resourced by:			
capital receipts	7,831.0	6,803.0	9,051.00
captial grants	7,715.0	6,791.0	8,312.00
revenue	1,237.0	900.0	689.00
unfinanced capital expenditure (additional need to borrow)	**1,509.3**	**5,914.8**	**1,922.00**

16. The figures in this table can be seen in the Statement of Accounts for 2007/08 in the Balance Sheet Note 6.15.

The Council's Overall Borrowing Need

17. The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This figure is a gauge for the Council's debt position. It represents 2007/08 and prior years net capital expenditure which has not yet been paid for by revenue, capital receipts or other capital resources

18. The total CFR can be reduced by:
    - The application of additional capital resources, such as unapplied capital receipts; or
    - Charge a voluntary revenue provision (VRP) or depreciation against it

19. The table below shows the Council's CFR position, and this represents a key prudential indicator.

CFR (£000's)	31st March 2007 Actual	31st March 2008 Estimate	31st March 2008 Actual
opening balance	6,007.0	7,517.0	7,517.0
plus unfinanced capital expenditure	2,320.2	0.0	2,137.0
minus MRP/VRP	-810.2	-210.0	-89.0
closing balance	7,517.0	7,307.0	9,565.0

20. The figures in this table can also be seen in the Statement of Accounts for 2007/08 in the Balance Sheet Note 6.15.

Treasury Position at 31st March 2008

21. Whilst the Council's gauge of its underlying need to borrow is the CFR, the Section 151 Officer and the treasury function can manage the Council's actual borrowing position by either:
    - Borrowing to the CFR;
    - Choosing to utilise some temporary cash flow funds, which will reduce our investment balance, instead of borrowing (under borrowing);
    - Borrowing for future increase in the CFR (borrowing in advance of need)

22. It should be noted that the accounting practice required to be followed by the Council (the SoRP) changed in 2007/08 accounts, and required financial instruments (debt and investments) in the accounts to be measured in a method compliant with national Financial Reporting Standards. The figures in this report are based on the actual amounts borrowed and invested and therefore may differ slightly to those in the final accounts.

23. During 2007/08 the Section 151 Officer managed the debt position to be stable, no new debt was taken out and a maturity loan of £3m was repaid in June 2007 which has meant a reduction in our overall debt. At the end of 2007/08 the Council had total debt of £9.9m. This debt belongs wholly to the HRA and repayment of it is provided for within our Housing Subsidy. This means there is no benefit to the Council to repay this debt as it will increase our Housing Subsidy. The Council's treasury position as at the 31st March 2008 compared with the previous year was:

	31st March 2007		31st March 2008	
Treasury Position	**Principal £000s**	**Average Rate**	**Principal £000s**	**Average Rate**
Borrowing				
Fixed interest rate debt	11,277.1	10.22%	7,746.8	10.78%
Other long term liabilities	2,320.3	4.52%	2,109.9	5.02%
Variable interest rate debt	0.0	0.00%	0.0	0.00%
Total Debt	**13,597.4**	**9.25%**	**9,856.7**	**7.90%**
Investments				
Fixed interest investments	32,615.0	4.94%	31,100.0	5.60%
Variable interest investments	0.0	0.00%	0.0	0.00%
Total Investments	**32,615.0**	**4.94%**	**31,100.0**	**5.60%**
Net Borrowing Position	**-19,017.6**		**-21,243.3**	

24. The figures in this table can also be found in the Statement of Accounts in the following areas:

- Fixed interest rate debt is shown in note 6.27 plus ‘Short Term Investments’ taken from the Balance Sheet 5.5. The difference is due to the changes made to how the accounts are produced to be compliant with national Financial Reporting Standards.
- Other long term liabilities is shown in note 6.29.
- Fixed interest investments are shown in the Balance sheet 5.5 in the line ’investments’, again the difference is due to the changes made to how the accounts are produced to be compliant with national Financial Reporting Standards.

Prudential indicators and compliance issues

25. Some of the prudential indicators provide either an overview or specific limits on treasury activity. These are shown below

26. **Net Borrowing and the CFR** – 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, have exceeded the CFR for 2007/08 plus the expected changes to the CFR during 2008/09 and 2009/10. The table below highlights the Council’s net borrowing position against the CFR, and shows that it is well below. The Council has complied with this prudential indicator.

	31st March 2007 Actual £000	**31st March 2008 Estimate £000**	**31st March 2008 Actual £000**
Total Debt	13,597.4	9,857.0	9,856.7
Total Investments	32,615.0	40,000.0	33,100.0
Net Borrowing Position	**-19,017.6**	**-30,143.0**	**-23,243.3**
CFR	**7,517.0**	**7,307.0**	**9,565.0**

27. **The Authorised Limit** – The authorised limit is the ‘affordable borrowing limit’ required by S3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2007/08 the Council has maintained gross borrowing within its Authorised limit. The authorised limit allows us to borrow to our future CFR if required, and this has been reflected in the limit itself, with a little headroom built in.

28. **The Operational Boundary** – The operational boundary is the expected borrowing position of the Council during the year, and periods occurring where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached. This limit is set to reflect the potential of borrowing to match our future borrowing requirements.

29. **Actual financing costs as a proportion of net revenue stream** – This indicator identifies the trend in the cost of capital (borrowing and

other long term obligation costs net of investment income) against the net revenue stream.

	2007/08 £000s
Indicators	
Original Indicator - Authorised Limit	22,400
original Indicator - Operational Boundary	13,900
Actuals	
Minimum gross borrowing position	9,857.0
Maximum gross borrowing position	13,597.4
Average gross borrowing position	11,727.2

Financing costs as a proportion of net revenue stream - General Fund	4.97%
Financing costs as a proportion of net revenue stream - HRA	5.82%

Economic Background for 2007/08

30. The rising trend in UK interest rates continued in the first half of the 2007/08 financial year. The domestic economic backdrop continued to present problems for the Monetary Policy Committee, notably in the early summer. CPI inflation breached the 3% upper limit of the Government's target range in April (reported in May), consumer spending growth remained buoyant and an expanding number of companies expressed intentions to raise prices.

31. The official Bank Rate was raised to 5.5% in May and again to 5.75% in July, in response to the deteriorating inflation outlook. In addition, the Bank of England's May and August Inflation reports hinted that more hikes might be necessary.

Interest Rates

	Bank Rate	LIBOR			PWLB Rates		
		3mth	6mth	1yr	5yr	20yr	50yr
Mar-07	5.25	5.6	5.8	5.9	5.35	4.80	4.45
Jun-07	5.50	6.0	6.1	6.3	5.80	5.20	4.80
Sep-07	5.75	6.3	6.3	6.2	5.25	5.00	4.75
Dec-07	5.50	6.0	6.0	5.8	4.64	4.63	4.47
Mar-08	5.25	6.0	6.0	5.8	4.14	4.70	4.43

32. The market was plunged into chaos in late August as the tightening of credit conditions, triggered initially by the failure of a selection of US mortgage lending institutions, undermined investor confidence. LIBOR rates rose to well over 6.5% as financial organisations' reluctance to lend money to counterparties sparked a severe shortage of funds in the market. In the UK, the crisis came to a head with the failure of the Northern Rock Bank (September) and while the danger of potential meltdown was defused by the Government's decision to guarantee all

deposits with this institution, this failed to prevent a prolonged tightening of credit conditions.

33. Central banks strove to boost market liquidity via the injection of funds to the banking system and there were signs that this might be working in January. But a series of disappointing financial results and a persistent undercurrent of mistrust ensured a wide margin between official and market rates continued to year end.

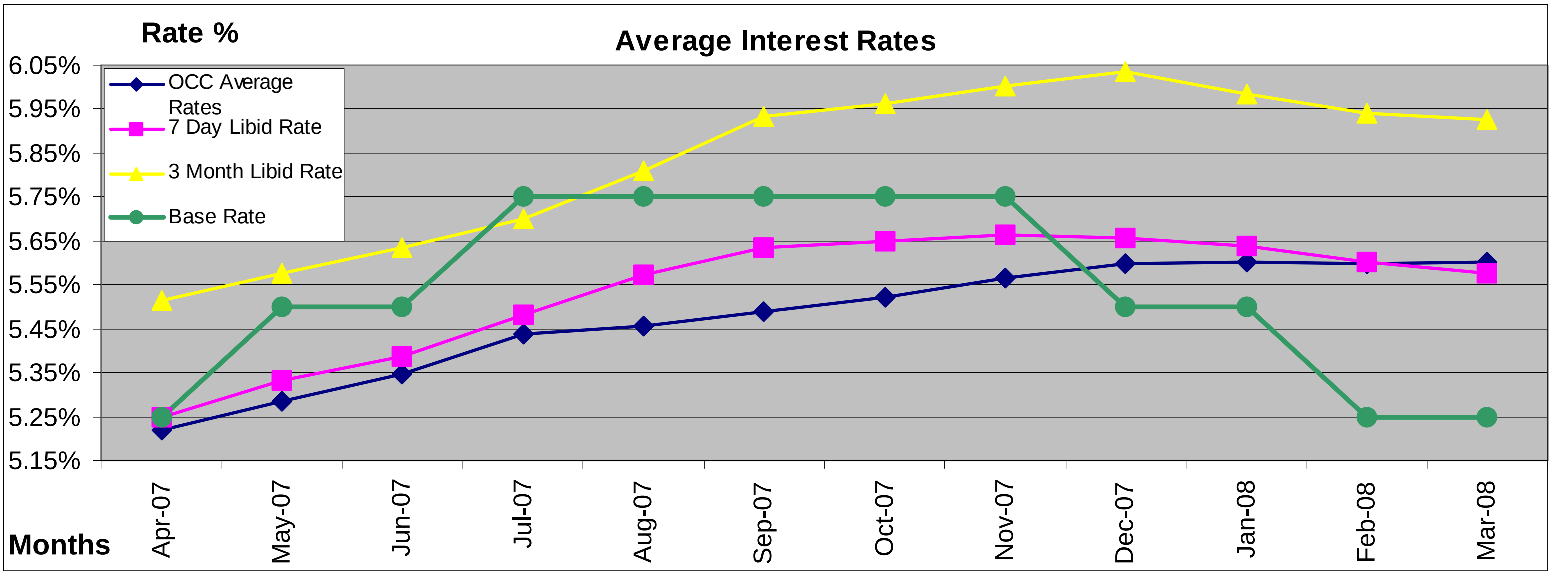
34. The credit crisis provoked a significant change in the Bank of England's assessment of UK economic prospects over the medium term. It was clearly concerned that the tightening of liquidity and the consequent rise in borrowing rates across the entire economy could lead to a rapid slowdown in activity. This would help to contain inflation pressures. Bank Rate was cut by 0.25% on two occasions, December and again in February, to end the year at a low of 5.25%.

35. Long term rates charted an erratic course. The upward pressure on rates in evidence in the closing stages of 2006/07 continued into the new year as concerns persisted that international interest would need to rise further to combat mounting inflation pressures.

36. Gilt yields peaked in late June and started to slip lower in the summer months. The flight to safe investments triggered by the financial crisis placed strong downward pressure upon gilt-edged yields in August and September notably at the short end of the maturity range and the rally in this part of the maket gained momentum as the year drew on.

37. Progress to lower levels was erratic and limited in the early months of 2008, but the general trend in yields was to lower levels. The most notable development was the reversion of the yield curve to a strongly positive incline.

38. The following graph shows the Councils achievement of average interest rate in comparison to the base rate and also in comparison to the benchmarks of 3month Libid and 7 day Libid.



39. The 3 month Libid rate rose much higher than the base rate due to the credit crunch crisis, therefore we introduced a second measure of the 7 day Libid which was a much more sustainable and prudent measure, and we look to continue to measure our performance against both targets.

The Strategy Agreed for 2007/08

40. The Section 151 Officer has delegated powers to determine the need for any future borrowing and the most appropriate form of borrowing depending on the prevailing interest rates at the time, taking into account any associated risks. It is likely that longer term fixed rates will be considered if borrowing levels remain relatively low.

41. The Section 151 Officer also has delegated powers to undertake the most appropriate forms of investments depending on the prevailing interest rates at the time, taking into account the risks, and will maintain a counterparty list in compliance with the agreed criteria.

42. The primary principle governing the Council's investment criteria is the security of its investments, although liquidity and yield are also a consideration. After this main principle the Council will ensure
    - It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed
    - It maintains a policy covering both the categories of investment types, criteria for choosing investment counterparties and adequate security, and monitoring their security.

43. The Strategy agreed in February 2007 stated that expectations on shorter-term interest rates, on which investment decisions are based, showed a likelihood of a peak of 5.25% in early 2007. The base rate

actually peaked at 5.75% between July and December 2007, falling to a low of 5.25% by the end of the financial year.

Actual Debt Position

44. No new external borrowing was undertaken during 2007/08, although the Council did continue to use unsupported borrowing to help finance the purchase of vehicles. This was financed from internal resources.

45. The Council will continue to consider the use of prudential borrowing in its ‘spend to save’ schemes.

Actual Investment Position

46. The Council’s investment policy is governed by ODPM (now CLG) Guidance, which has been implemented in the annual investment strategy approved by Council in April 2007. The investment activity during the year conformed to this strategy, and the Council had no liquidity difficulties.

47. The Council invests in various banks and building societies throughout the year, and always remains within the limits set out within the TM Strategy approved by Council. During 2007/08 the Council maintained an average invested balance of £39.9m and received an average return of 5.60%. The comparable performance indicator is the average 7-day LIBID rate, which was 5.58%.

48. The original budget for interest receivable in 2007/08 was £2.286m and was increased to £2.616m in October 2007year in line with rising interest rates. A forecast reduction was made of £90k, with a final forecast of £2.526m at the end of the year. The Council achieved interest of £2.447m which was below the budget but this was due to interest rates fluctuating greatly in the last quarter of the financial year. This compares with a budget assumption of £42m investment balance at 5.25% interest rate.

Proposed changes to Counterparty limits

49. The Council has between £40m and £50m invested in the money market at any one time, this is predominantly invested in periods upto 1 year.

50. Following the credit crunch, and the near collapse of Northern Rock, the resultant lack of confidence in the market and the security offered by borrowers, many counterparties have since had their credit rating re assessed and in many cases they have been lowered. Fitch, Moodys and Standard & Poors are the three credit rating agencies that provide credit ratings for banks and building societies.

51. This has led to counterparties being removed from our authorised counterparty list. Those that have been removed have often been those that have offered the better rates in the market for the values that we have available to invest. Those that remain on our list and offer competitive rates, we use regularly to get the best rates possible. However we reach our limits with individual counterparties quite quickly then have to take lower rates with other counterparties. This has an overall effect on our interest earned in year, and also against our performance against the benchmark of 7 day LIBID.

52. We identified two possible ways to alleviate the pressures of placing funds to gain reasonable returns. The first is to relax our credit criteria to allow extra counterparties onto our list. The second is to increase limits for the highly rated counterparties that our lowest common denominator criteria allows us to use. Given the uncertain nature of markets highlighted above, it was recommended by Butlers that we propose the second option of raising limits within the existing criteria. This will maintain the strong approach to risk in our investment strategy while providing the Council sufficient flexibility to invest funds without having to compromise on the rate of return.

53. By using the lowest common denominator method for selecting counterparties, we ensure only the highest rated institutions are included, as this looks at all three rating agency's. Each counterparty has to meet the minimum criteria for Fitch, Moody's and S&P if rated by them.

54. The proposed limits are listed in the table below for approval. The changes are:
    - Raising the upper limit from £8m to £10m
    - Raising the middle limit from £5m to £7m
    - Raising the lower limit unrated building society category from £2.5m to £4m
    - Raising the upper limit unrated building society category from £5m to £7m
    - Raising the Money Market Fund limit from £8m to £10m

	Fitch	Moody’s	Standard & Poors	Money Limit	Time Limit
Banks & Building Societies					
Upper Limit Category	*F1+/AA-*	P-1/Aa3	A1+/AA-	£10.0m	>364 days
Middle Limit Category	F1/A-	P-1/A3	A-1/A-	£7.0m	<365 days
Unrated Building Societies					
Lower Limit Category	Asset base between 0.5bn and 2bn			£4.0m	183 days
Upper Limit Category	Asset base greater than 2bn			£7.0	< 365 days
Other					
Money Market Fund				£10.0m	
Other Institution Limits	-	-	-	£10.0m	364 days

Regulatory Framework, Risk and Performance

55. The Council’s treasury management activities are regulated by a variety of professional codes and statutes and guidance.
    - The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;
    - The Act permits the Secretary of State to set limits either on the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken, no restrictions were made in 2006/07;
    - Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;
    - The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;
    - The SI also requires the Council to operate the overall treasury function with regard to the CIPFA Code of Practice for Treasury Management in the Public Services;
    - Under the Act the DCLG has issued investment guidance to structure and regulate the Council’s investment activities
    - Under section 238(2) of the Local Government and Public Involvement in Health act 2007 the Secretary of State has taken powers to issue guidance on accounting practices. Guidance on Minimum Revenue Provision was issued under this section on 8th November 2007.

56. The Council has complied with all of the above relevant statutory and regulatory requirements which limit the levels of risk associated with its treasury management activities. In particular its adoption and implementation of both the Prudential Code and the Code of Practice for Treasury Management means both that its capital expenditure is prudent, affordable and sustainable, and its treasury practices demonstrate a low risk approach.

57. The Council is aware of the risks of passive management of the treasury portfolio and, with the support of Butlers, our Treasury advisors, has proactively managed its treasury position.

Recommendation(s): The City Executive Board is asked to recommend Council to:

1) **Approve the actual 2007/08 prudential indicators within the report**
2) **Note the treasury management annual report for 2007/08**
3) **Recommend to Council the approval of the proposed changes to the counterparty list as stated within the report**

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Background papers: None