Annex 4

TREASURY MANAGEMENT AND INVESTMENT STRATEGY REVIEW 2008/09

1.1 Introduction and Background

1.1.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management 2001 was adopted by this Council on 30 September 2003 and this Council fully complies with its requirements. The primary requirements of the Code are the: -

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

- Receipt by the Cabinet / Council of an annual strategy report for the year ahead and an annual review report of the previous year.

- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

1.1.2 Treasury management in this context is defined as:

"The management of the local authority's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. "

1.1.3 This annual treasury report covers:

- The Council's treasury position at 31 March 2009.
- Performance measurement.
- The strategy for 2008/09.
- The economy and reality for 2008/09.
- Borrowing and investment rates in 2008/09.
- The borrowing outturn for 2008/09.
- Compliance with treasury limits and prudential indicators.
- Investment outturn for 2008/09
- Icelandic investment.

1.2 Treasury Position at 31 March 2009

1.2.1 The Council's debt and investment position at the beginning and the end of the year was as follows:

	31st March 2009 £m	**Rate/ Return**	**Average Life yrs**	**31st March 2008 £m**	**Rate/ Return**	**Average Life yrs**
Variable Rate Funding:						
- Overdraft	£nil	N/A	N/A	£nil	N/A	N/A
Total Debt	**£nil**	**N/A**	**N/A**	**£nil**	**N/A**	**N/A**
Fixed Rate Investments:						
In-House-Cash flow	£1.29	1.18%	0.01	£ 2.71	5.71%	0.01
In-house-Cash flow - Landsbanki	£1.00	See para 1.10				
In-House - Core	£10.00	6.16%	1.27	£12.00	5.86%	1.03
Fund Managers	£14.46	1.66%	0.44	£13.03	5.88%	0.44
Variable Rate Investments:						
- In-House and Externally Managed	Nil			Nil		
Total Investments	**£26.75**	**3.26%**	**0.74**	**£27.74**	**5.85%**	**0.65**

1.3 Performance Measurement

1.3.1 One of the key changes in the revision of the Code in 1996 was the formal introduction of performance measurement relating to investments, debt and capital financing activities. The use of benchmarks for investments is appropriate to a portfolio of our size and these have been well developed and universally accepted.

1.4 The Strategy for 2008/09

1.4.1 The Sector recommended treasury strategy for 2008/09 (in January 2008) was based on their view of a declining rate of growth of GDP in the UK economy from the peak of 3.3% in Q3 2007 to 2% in 2008. Bank Rate was expected to continue falling from 5.75% in November 2007 to reach 5.0% in Q2 2008 and then stay there for the rest of the financial year. This was based around the dilemma facing the MPC of balancing the opposing risks of inflationary pressures driven by spikes in oil prices against concerns around the impact of the credit crunch both on the UK housing market and economy and even more so in the US housing market and economy and the knock on impact on world growth rates.

1.4.2 The effect on interest rates for the UK was therefore expected to be as follows:

- **Shorter-term interest rates** - The "average" City view anticipated that Bank Rate would be stable in 2008/09 at 5.25% based on a balance of risks around rising inflationary pressures on the one hand and falling growth rates and concerns over the impact of the credit crunch on the other hand.

- **Longer-term interest rates** - The view on longer-term fixed interest rates, 50 years, was that they would remain static around 4.45% for the whole of the year. The 25 year rate would also remain flat around 4.50% - 4.55%.

1.4.3 The strategy adopted by the Council based upon the above forecast was to:

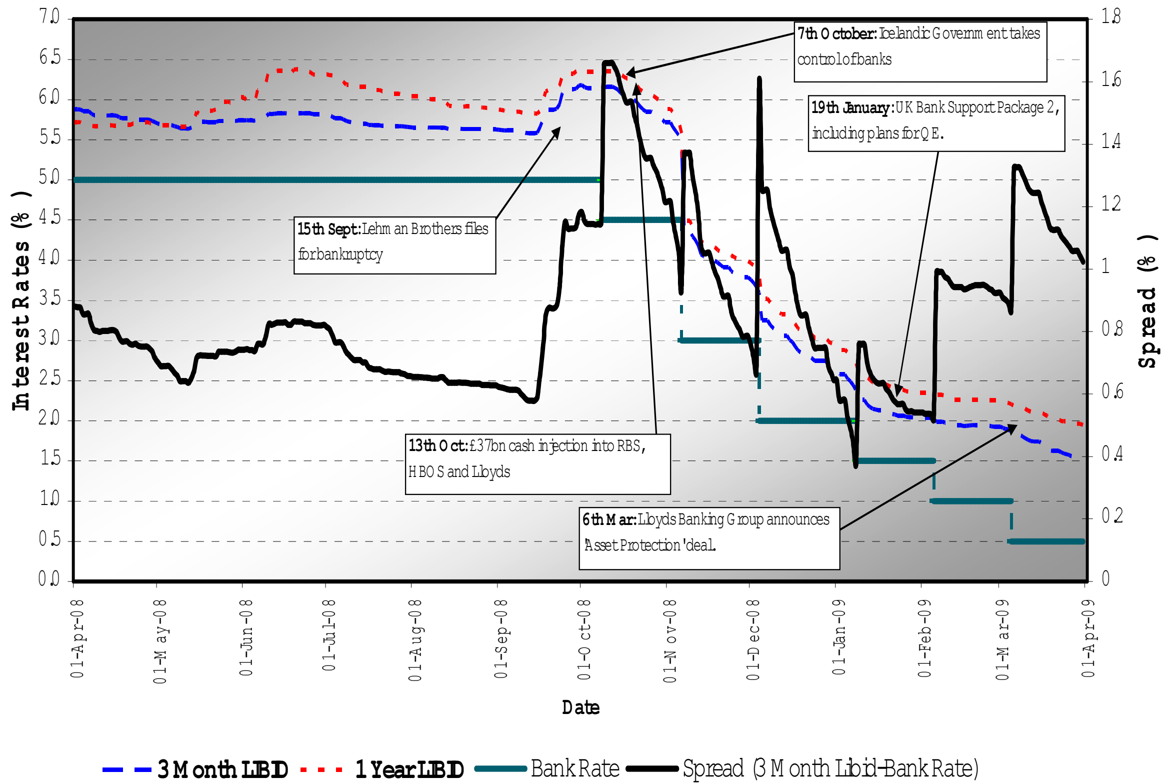
- Re-invest the "core fund" maturities in July 2008 at rates consistent with the trigger rates identified by Sector at that time.
- Continue the use of business accounts, base rate and short-dated deposits (1-3 months) as a means of benefiting from the compounding of interest on short-term internal cash flow balances; and for
- The bulk of externally managed investments to be held in longer dated Certificates of Deposit (CD's) supplemented by strategic investment in gilts to secure a return of 5.5%.

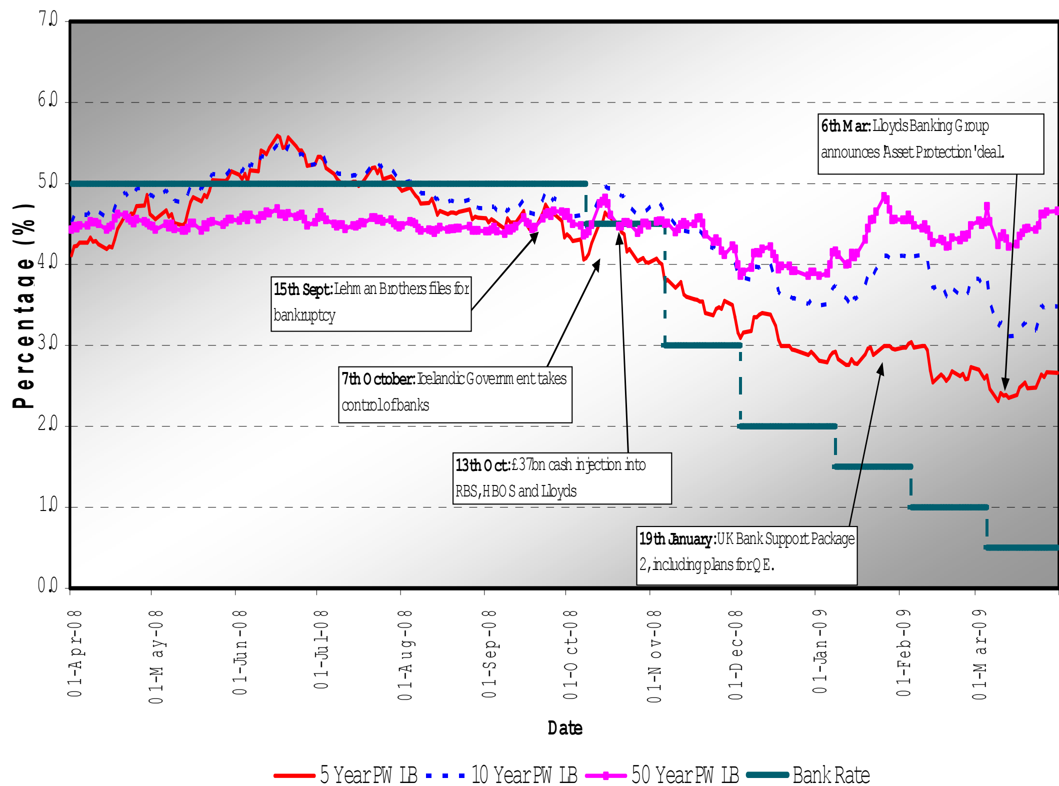
1.4.4 The strategy adopted in the Treasury Management Strategy Report for 2008/09 did not need to be revised during the year despite the unprecedented impact of the credit crunch on world economies and the world banking system. This impact resulted in a rapid fall in central bank rates around the world during the year, including in the U.K.

1.5 The Economy and Reality for 2008/09

1.5.1 In a year that can only be described as unparalleled and extraordinary the Annual Treasury Report for 2008/09 is summarised in the graphs below. These graphs show the major events of the financial year and the impact they had on both PWLB and investment rates. The financial crisis, commonly known as the 'credit crunch', had a major downward impact on the levels of interest rates around the world. Although interest rates initially fell sharply in the US they were followed, eventually, by the Bank of England.

Annex 4





1.5.2 On 1st April 2008 Bank Rate was 5% and the Bank of England was focused on fighting inflation. Market fears were that rates were going to be raised as CPI, the Government's preferred inflation target, was well above the 2% target (two years ahead). The money market yield curve reflected these concerns with one year deposits trading well above the 6% level. PWLB rates in both 5 and 10 years edged above Bank Rate during the summer as markets maintained the belief that inflation was the major concern of the monetary authorities. The money markets were reflecting some concerns about liquidity at this time and, as shown in the graph, the spread between Bank Rate and 3 month LIBOR was greater than had historically been the case.

1.5.3 This phase continued throughout the summer until the 15th September when Lehman Brothers, a US investment bank, was allowed to file for bankruptcy in the total absence of any other institution being willing to buy it due to the perceived levels of toxic debt it had. This event caused a huge shock wave in world financial markets and threatened to completely destabilise them. As can be seen from the charts this also led to an immediate spike up in investment rates as markets grappled with the implications this might have on other financial institutions, their credit standing and indeed their viability. On 7th October the Icelandic government took control of their banks and this was followed a few days later by the UK government pumping a massive £37bn into three UK clearing banks, RBS/HBOS/Lloyds, as liquidity in the markets dried up. The Monetary Policy Committee meantime had reduced interest rates by 50bp on 9th October. This had little impact on 3 month LIBOR, however, as the spread, or 'disconnect' as it became known, against Bank Rate widened out. On the other hand the short end of the PWLB fell dramatically as investors, very concerned about their counterparty limits post the Icelandic banks' collapse, fled to the quality of Government debt forcing yields lower.

1.5.4 Market focus now shifted from inflation concerns to concerns about recession, depression and deflation. Although CPI was still well above target it was seen as no barrier to interest rates being cut further. The MPC duly delivered another cut in interest rates in November, this time by an unprecedented 1.5%. Investors continued to pour money into Government securities across the curve, at the front end because of credit concerns and the longer end because of the economic consequences reducing inflation, driving yields in 10 year PWLB temporarily below 4% and 5 years to around 3.5%. In December as the ramifications of the 'credit crunch' became increasingly clear the Bank of England cut interest rates to 2% - a drop this time of 1%. The whole interbank yield curve shifted downwards but the 'disconnect' at

the short end remained very wide, negating to some degree the impact of the cuts in Bank Rate. 50 year PWLB rates dropped below 4% at the turn of the year, marking the low point, as it turned out, in this maturity.

1.5.5 The New Year of 2009 brought little relief to the prevailing sense of crisis and on 8th January the MPC reduced rates by 0.5% to 1.5%, a record low. More Government support for the banking sector was announced on 19th January 2009. The debt markets had a sharp sell-off at this stage as they took fright at the amount of gilt issuance likely to be needed to finance the help provided to the banks. There was also discussion about further measures that could be introduced to kick start lending and economic activity. These included quantitative easing by the Bank of England, effectively printing money.

1.5.6 In February 2009 the MPC adopted the traditional method of monetary easing by cutting interest rates again by 0.5% to 1%. Interbank rates drifted down with the spread in the 3 months still well above Bank Rate. In early March Lloyds Banking Group, which now included HBOS, took part in the Government's Asset Protection scheme. The MPC cut interest rates yet again to 0.5% and announced the quantitative easing scheme would start soon. This scheme would focus on buying up to £75bn of gilts in the 5-25 year maturity periods and £10 -15bn of corporate bonds. This led to a substantial rally in the gilt market, particularly in the 5 and 10 year parts of the curve, and PWLB rates fell accordingly. Finally at the end of March it was announced that the Dunfermline Building Society had run into difficulties and its depositors and good mortgages were taken over by Nationwide whilst the Treasury took on its doubtful loans.

1.5.7 The financial year ended with markets still badly disrupted, the real economy suffering from a lack of credit, short to medium term interest rates at record lows and a great deal of uncertainty as to how or when recovery would take place. Investment income returns have been badly hit, but lower borrowing rates in short to medium periods had allowed indebted local authorities to benefit.

1.6 Borrowing and Investment Rates in 2008/09

Shorter-term interest rates

1.6.1 One year LIBID fluctuated between 5.7% and 6.4% with two peaks driven by credit crunch fears in June and September. Bank Rate had been held at 5.0% until October 9 when the first of a series of major

cuts caused 12 month LIBID in 2008/09 to be on a rapidly falling trend to 1.85% by the end of the financial year.

5 (and 10 year) gilt yields

1.6.2 These yields have been very volatile during the year. In April, they started at around 4.1% (4.4%) and peaked at around 5.5% (5.2%) during June before edging down again to around 4.4% (4.5%) in mid September. After Lehman's then collapsed, yields were on a generally falling trend although volatility was again pronounced with a mini peak in late January around 2.9% (3.0%) before finishing the year at around 2.3% (2.4%).

Longer-term interest rates

1.6.3 The PWLB 45-50 year rate started the year at 4.43% (25 year at 4.62%) and was then generally within a band of 4.3 - 4.6% (4.6% - 5.0%) until mid October when there was a spike up to 4.84% (5.08%) followed by a plunge down to 3.86% (4.03% late December) in early December. Further spikes of 4.84% (4.86%) and 4.72% (4.69%) occurred in late January and early February with the year closing out at 4.58% (4.28%).

1.7 Treasury Borrowing for 2008/09

1.7.1 In accordance with the Treasury Management Strategy borrowing was limited to use of the bank overdraft to support cash flow. Such borrowing was undertaken on a daily basis and was within the £0.5m limit set within the Treasury Management and Investment Strategy adopted by the Council in February 2008 on all but three occasions, when unexpected cash flow movements resulted in the Director of Finance authorising a temporary increase.

1.8 Compliance with Treasury Limits and Prudential Indicators

1.8.1 Throughout the financial year the Council operated within the treasury limits and prudential indicators set out in the Council's Treasury Management and Investment Strategy, apart from the three days on which the borrowing on overdraft limit was exceeded in order to meet unexpected cash flow demands.

1.8.2 The outturn for the other prudential indicators relevant to this outturn report are shown in the table below:

1. Ratio of actual and estimated financing costs to the net revenue stream			(Interest payable with respect to borrowing less interest and investment income) ÷ (government grants plus call on local taxpayers) x 100%.				
2007/08 actual	2008/09 original estimate	2008/09 revised estimate	2008/09 actual	2009/10 estimate	2010/11 estimate	2011/12 estimate	2012/13 estimate
-14.88%	-11.83%	-13.81%	-14.22%	-6.24%	-5.32%	-4.99%	-5.06%

2. Actual and estimated capital expenditure			This indicator is based on the capital plan position shown in the Blue Budget Book for 2009/10. The 2008/09 actual figures reflect capital accruals at 31st March 2008 (-£260k) and 31st March 2009 (£146k). The 2009/10 figures have not been adjusted for slippage from 2008/09 but reflect capital accruals at 31st March 2009.				
2007/08 actual	2008/09 original estimate	2008/09 revised estimate	2008/09 actual	2009/10 estimate	2010/11 estimate	2011/12 estimate	2012/13 estimate
£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
3,781	4,721	4,727	3,687	4,563	2,466	1,602	1,648

1.9 Investment Outturn for 2008/09

1.9.1 The Council continued to manage its cash flow and part of its core investments in-house and invests with the institutions listed in the Council's approved lending list. The Council invests for a range of periods from overnight to 3 years, dependent on the Council's cash flows, its interest rate view and the interest rates on offer.

1.9.2 The Council also has core investments managed externally by Investec Asset Management. The fund management agreement between the Council and the Fund Manager defines the limits for maximum weighting in gilts, CDs and bonds and maximum duration of the fund. Counterparty criteria and exposure limits are also pre-defined therein.

1.9.3 Throughout the last financial year the characteristic of market interest rates was set by the continuing lack of liquidity in the market place with banks remaining uneasy about lending. Continuing fears around the credit crunch, and so heightened credit spreads, forced the level of all market rates higher than in normal times. Whilst this was a desperate time for borrowers the flip side of the ensuing problems was that investors were the benefactors of these conditions, with deposit rates remaining inflated by high credit spreads and thus enabling an element of core funds to be lent in the longer term to secure good returns over the course of the next 12-36 months.

1.9.4 The collapse of Lehman's and the Icelandic banking system in September/October 2008 created an environment of fear, and the nationalisation and part nationalisation of many financial institutions was necessary to secure the global financial system in the face of hundreds of billions of pounds worth of toxic asset related losses. Governments commenced a series of stimulus packages aimed at kick starting the global economy and central banks, helped by a downturn in inflation and inflation expectations, and so began an aggressive policy of interest rate cuts which has seen interest rates, though maintaining elevated credit spreads, crashing to record low levels.

1.9.5 During the year we and Investec sought to take advantage of this interest rate scenario to lengthen the duration of our portfolio by, generally, investing maturities into the longer term. Over the course of the financial year the duration of the portfolio has therefore been kept fairly long and at the year end stood at 240 days. The overall return for the financial year was 5.66% exclusive of unrealised gains against an uncompounded 7 day LIBID of 3.63%, The actual results for the three parts of our portfolio are summarised in the table below:

	Average Investment £m	Rate of Return (gross of fees/costs)	Rate of Return (net of fees/costs)	Benchmark Return
Internally Managed – Cash Flow	£8.8m	4.89%	4.53%	3.63%
Internally Managed – Core Investments	£12.2m	6.07%	5.90%	3.63%
Externally Managed – Core Investments	£13.1m	5.8% Excluding unrealised gains	5.6% Excluding unrealised gains	3.63%

1.9.6 It was pleasing to note that in such a difficult environment over the course of the year a return of £1.93m (excluding unrealised gains) was achieved against an original estimate of £1.65m and a revised estimate of £1.92m.

1.10 Icelandic Bank Defaults

1.10.1 Counter party risk was kept under constant review throughout the year and various counter parties were removed or suspended from our lending list in response to credit ratings changes and information

received from a number of sources. However, as members will be aware from my report to Cabinet on 19 November 2008 and to the Finance and Property Advisory Board on 20 May 2009 this did not prevent us suffering a default on a £1m investment with the Icelandic bank, Landsbanki, on 30 October 2008.

1.10.2 The Icelandic Government has stated its intention to honour all its commitments as a result of their banks being placed into receivership. The U.K. Government is working with the Icelandic Government to help bring this about. At the current time it is not possible to say with certainty that we will recover the entirety of our investment(s) or when reimbursements will be made to this authority. The Local Government Association is coordinating the efforts of all UK authorities with Icelandic investments.

1.10.3 The Government, the National Assembly of Wales and the Scottish Parliament have all issued regulations allowing local authorities for budget setting purposes to delay recognising any loss that may eventually be incurred from non-repayment of the original investment until the financial year 2010/11.

1.10.4 Members will be periodically updated on the latest developments on these efforts and may like to refer to my report to the Finance and Property Advisory Board on 20 May 2009 which sets out in detail our response to the findings of the Audit Commission, Treasury Select Committee and CIPFA in respect of the Icelandic banks crisis. It is of little comfort to report that we were found to have acted properly in managing our investments by the Audit Commission. I can assure members steps have and will be taken to further strengthen our treasury management operations and remain hopeful that most if not all of our investment will be recovered.