D

# SCRUTINY COMMISSION – 23RD JULY 2008

# ANNUAL TREASURY MANAGEMENT REPORT 2007/2008

# REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

## Purpose of Report

1. To report on the action taken and the performance achieved in respect of the treasury management activities of the Council in 2007/08.

2. Under the CIPFA Code of Practice it is necessary to report on treasury management activities undertaken in 2007/2008 by the end of September 2008, although the County Council's own policy is to produce a report before the end of July.

## Background

2. The term treasury management 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".

3. The Director of Corporate Resources is responsible for carrying out treasury management on behalf of the County Council, under guidelines agreed annually and contained within the Treasury Management Policy. Part of the policy is the requirement to report on the performance by the end of July following each year-end.

## Treasury Management 2007/2008

4. There were no departures from the Treasury Management Policy Statement which was agreed by the full Council on 21st February 2007 in relation to the sources and methods of borrowing and approved organisations for lending temporarily surplus funds.

5. The list of available counterparties to whom surplus funds can be lent is based on credit ratings assigned to each institution by independent agencies, and Leicestershire's policy for lending to banks is to only include those with the highest possible long-term rating and very good short-term ratings. There are occasions when a counterparty is downgraded to a rating that would see them no longer satisfy our requirements, at which time no monies can be lent to them. If the downgrading happens when a loan is already in place there is no way of getting a premature repayment, so the loan has to be allowed to mature. This usually

happens infrequently, but the number of rating downgrades in the aftermath of the sub-prime crisis has seen a far greater incidence over the last 6 months.

6. The recent downgrading of Alliance & Leicester to below a rating that is acceptable to ourselves occurred when three loans totalling £15m had been placed with them. Of the 3 loans (all of £5m each) two mature in November 2008 and one in May 2009. These loans do not breach the existing policy – they were all placed when Alliance & Leicester satisfied the very high rating requirements – but it was thought worthwhile bringing it to members' attention due to the sums involved and the relatively long period until the last maturity. Whilst it is impossible to rule it out entirely, the risk of default is thought to be very low.

## Position at 31st March 2008

7. The Council's debt position at the beginning and end of the year was as follows:-

| | 31st March 2008 | | | 31st March 2007 | | |
|---|---|---|---|---|---|---|
| | Principal | Average Rate | Average Life | Principal | Average Rate | Average Life |
| **Fixed Rate Funding** | | | | | | |
| - PWLB | £254.1m | 5.91% | 44 yrs | £277.6m | 5.86% | 44 yrs |
| -Market | £ 2.0m | 8.12% | 9 yrs | £ 2.0m | 8.12% | 10 yrs |
| **Variable Rate Funding:** | | | | | | |
| - Market (1) | £103.5 m | 4.00% | 2 yrs | £ 70.0 m | 3.46% | 3 yrs |
| **Total Debt** | £359.6m | 5.33% | 32 yrs | £349.6m | 5.39% | 36 yrs |

(1) £10m at 4.5% and £10m at 4.75% but subject to variation every 6 months by lender, with our option to repay in the event of a variation. Remaining £83.5m has rates guaranteed for between 2 months and 7 ½ years, after which interest may be payable at a higher rate and generally subject to a 6 month variation. These loans all have an option to repay in the event of a variation.

8. The position in respect of investments varies throughout the year as it depends on large inflows and outflows of cash. It is also complicated by the fact that the County Council pools its own cash with that belonging to a large number of schools with devolved banking arrangements, the Pension Fund and ESPO when dealing in the London money markets. The available balance varied during 2007/08 between £130m and £200m, and at the end of the 2007/08 financial year stood at £179m.

## Borrowing Undertaken in 2007/2008

9. Rates for medium and longer term borrowing were relatively volatile over the course of the year, with the 45-50 year rate available from the Public Works Loan Board (PWLB) – generally the most appropriate source of borrowing for the Council – ranging between a high of 4.90% and a low of 4.38%. The lowest rates available were at the end of the financial year, as the continuing impact of the credit crunch that had begun with a crisis in US sub-prime loans had a significant impact on the attractiveness of other assets. Bonds tend to be more attractive to investors when the future outlook for other asset classes is unclear and when the outlook for economic activity is poor – both of which existed (to varying degrees) from the start of the credit crunch in August 2007.

10. In April 2007 loans totalling £24.4m, an average rate of 4.55% and over 50 years to maturity were repaid to PWLB, with the intention of replacing the loans when rates reduced. These rate reductions did not happen as quickly as had been anticipated – in fact rates continued to move upwards, and further repayments totalling £12.8m (average rate of 4.81%) were made in the following months. This action had an initial cost to the Council – we had effectively replaced (albeit temporarily) external

debt with an average rate of 4.63% with internal borrowing that forewent a rate of above 5.5% - and the lack of any meaningful reduction in borrowing rates made it an uncomfortable period. Following the long-term rate reductions that followed the initial impact of the credit crunch, the position was ‘closed out’ by borrowing £37.2m in three tranches in August/September at an average rate of just over 4.5%. The rescheduling was ultimately successful in reducing the average rate of the debt portfolio, although the savings were not as high as would have been hoped for.

11. In October 2007 a package of three loans totalling £23.5m (average rate of 5.11%) were repaid to PWLB and a replacement market loan was taken at a rate of 4.15%.This replacement loan was in a LOBO (Lender’s Option, Borrower’s Option) structure, with the rate being guaranteed for the first year. Thereafter the lender has the option to vary the rate every 5 years, and if this happens we have the option to either accept the new rate or repay. Given the structure of the loan, it was deemed unlikely that the lender would exercise his option after the first year – the cost of doing so would be prohibitive unless there had been a significant change in interest rates over the period – so the funding is expected to remain in place for at least 6 years.

12. The final borrowing activity in the year was in a further LOBO structure, this time with a guaranteed period of 5 years (with 5 year ‘calls’ thereafter) at a rate of 4.025%. This loan was taken to pre-finance the 2008/09 capital programme at a rate that was thought to be very attractive. As all of the other borrowing activity related to debt rescheduling, it was the only genuinely new borrowing during the year.

13. The debt rescheduling exercises carried out were beneficial to the Council and, by pure chance, the timing was very good. On 1st November the PWLB made a number of changes to its lending policy, including the imposition of a higher rate when making premature repayments – there had previously been a single rate at which new loans could be raised in each period, with this same rate being used to calculate any premium/discount relating to a premature repayment. The rate differential varies depending on the maturity period, but in the longest period is about 0.45%. It is unlikely that any premature repayments to the PWLB will now be attractive, and the possibility of actively managing the debt portfolio has reduced drastically. None of the rescheduling exercises carried out during the year would have been considered if the new PWLB policy had been in place.

**<u>Investment Undertaken in 2007/08</u>**

14. Bank base rates began the year at 5.25% and were increased in two 0.25% steps in May and July 2007. At the time of the July increase the market anticipated at least one further base rate increase during the current cycle, with many economists predicting a peak of 6.25% or above. The necessity for further rate increases was based on increasing inflationary pressures, continued economic expansion and increasing consumer indebtidness.

15. At the time of the July base rate increase, the Council’s investment portfolio looked in a very poor state – a number of long term loans had been placed in the expectation that rates would not reach the levels that they already had done, and certainly would not have reached these levels so quickly. The prospect of further increases did not bode well for the relative performance of the portfolio – it would, however, be beneficial in absolute terms (i.e. we would earn more interest due to

higher interest rates becoming available). As far as the relative performance of the portfolio was concerned, the US sub-prime crisis and the resultant credit crunch could not have been better timed!

16. The expected impact onto economic activity of the implosion of the US property market quickly made markets reassess the likely path of UK base rates – they were, all-of-a-sudden, heading down rather than up. Simultaneously, however, the banks refused to lend to each other and the basic law of demand-and-supply came into play, with borrowers needing to pay much more for money than the outlook for base rates suggested that they should. For lenders such as the County Council it was an opportunity to lend to financial institutions with very high credit ratings at margins above base rate that were almost unprecedented. Initially the best rates were available for lending in the 3 – 6 month periods, presumably as borrowers thought that things would have become more normal by then. When it became apparent that the matter was not going to go away quickly, exceptionally attractive rates became available for lending to UK clearing banks for 1 year or more. The portfolio reacted to the changing market circumstances to place funds in the periods that were thought to be most beneficial for the Council in the medium term – inevitably, this has led to a portfolio with a longer average maturity period than would normally be expected.

**Performance of Portfolios**

17. The average rate achieved on investments during 2007/08 was 5.94%, which is 0.08%, above the Local Authority 7 day Return Index. This index calculates the rate that would be achievable if no longer-term decisions were taken, and makes an allowance for the reinvestment of interest earned. The average base rate for the year was 5.54%.

18. Since performance measurement of the investment portfolio commenced, Leicestershire has produced 13 consecutive years of outperformance of both the 7 day index and the average base rate and this has been achieved through active cash management. Over this period the portfolio has averaged a return of 0.32% p.a. over the 7 day index. The variable (and gradually increasing) amount of cash available to lend over this 13 year period makes it difficult to quantify the extra interest that has been generated over the whole 13 year period, but it is certainly in excess of £7m. Under normal circumstances it would be expected that the extent of the average outperformance will be reduced in the future (base rates are less volatile and the opportunities to add value are, therefore, not as great), although the continuing impact of the current credit crunch should mean that very significant outperformance is achieved in 2008/09. Quite when, or indeed if, rates of interest available in the market again start to reflect the expected path of base rates (as has historically been the case) is an unknown factor, but it seems unlikely that the premiums that are now available will persist in the long term.

19. Despite the successful action taken within the debt portfolio over the last year, the average rate only decreased by 0.06%. This is partly due to the fact that one variable rate loan increased from the low initial level of 2.99% to a market level of 4.75% (which in itself pushed the average rate up by 0.06%), and partly because there was only net new borrowing of £10m taken during the year – any new loans will inevitably be at below the current average and will reduce the average rate. The portfolio has a number of other 'stepped' LOBOs which will default to a higher rate in coming financial years, and the lack of rescheduling opportunities caused by the

PWLB policy change - combined with the relatively small amount of new borrowing that is required - will mean that there is a high likelihood of the average rate increasing marginally from the current level.

20. The only statistics available in respect of other debt portfolios comes via CIPFA, and are available a year in arrears. The statistics rely on each authority providing accurate data, and there are some authorities that appear to have unrealistically low average rates. The CIPFA statistics suggest that Leicestershire's external debt portfolio has a higher-than-average rate, despite the fact that our Treasury Management advisors (who also advise 200+ other authorities and have in-depth details of their portfolios) confirm that our rate is towards the lower end of their clients. According to the latest available CIPFA statistics (based on the position at 31st March 2007), the Leicestershire portfolio has an average rate that is 0.30% above the average English County.

**Summary**

21. Treasury Management is an integral part of the Council's overall finances and the performance in this area is very important. Whilst individual years are important, the matter is best viewed on a medium/long term basis. It is my belief that the action taken in respect of the debt portfolio in recent years has been beneficial, and the lending of surplus funds continues to add value year-on-year.

**Resources Implications**

22. Treasury management is an integral part of the County Council's finances. Interest on revenue balances generated over £8m in 2007/08 and the interest paid on external debt was over £19m. The interest received was £2m more than was included in the original budget, due to both cash balances and the rates available being consistently higher than expected.

**Equal Opportunities Implications**

23. None

**Recommendation**

24. The Commission is ASKED TO NOTE this report.

**Circulation Under Sensitive Issues Procedure**

None

**Officers to Contact**

Pat Sartoris – telephone 0116 3057642
Colin Pratt - telephone 0116 3057656

**Background Papers**

Report to County Council on 21st February 2007 – 'Medium Term Financial Plan': Appendix N 'Treasury Management Strategy Statement and Annual Investment Strategy 2007/08'.