CANNOCK CHASE COUNCIL

COUNCIL

25 JUNE 2008

REPORT OF DIRECTOR OF GOVERNANCE

ANNUAL TREASURY REPORT 2007-08

1. Purpose of Report

1.1 To advise Members of the Council's Treasury activities during 2007-08

2. Recommendation

2.1 That the contents of this report be noted.

3. Key Issues

3.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management 2001 was adopted by this Council on 4 March 2003 and this Council fully complies with its requirements. The primary requirements of the Code are the:-

(a) creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities;

(b) creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives;

(c) receipt by the Council of an annual strategy report for the year ahead and an annual review report of the previous year;

(d) 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.

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".

3.2 This annual treasury report covers:

- the Council's current treasury position;

- performance measurement;
- the strategy for 2007-08
- the economy in 2007-08;
- borrowing and investment rates in 2007-08;
- the borrowing outturn for 2007-08;
- compliance with treasury limits and Prudential Indicators;
- investment outturn for 2007-08;
- debt rescheduling;
- other issues

3.3 During 2007-08 the Council did increase its Long Term Borrowing Portfolio by £2.5 million

3.4 Although the investment return again exceeded the accepted benchmark of the uncompounded LIBID 7 day rate, investments were of necessity kept in small amounts and on the whole, short term (i.e. 3 months or less). This inevitably decreases the return available, but based upon market conditions in the year actually increases the amount of interest earned by the Council.

3.5 None of the prudential indicators set at the beginning of the year were exceeded and all investments were carried out with institutions listed in the Council's approved lending list.

REPORT INDEX

Section 1

1. Background

1.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management 2001 was adopted by this Council on 4 March 2003 and this Council fully complies with its requirements. The primary requirements of the Code are the:-

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Section 2

2. Details of Matters to be Considered

2.1 Current Treasury Position

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

	31 March 2008 Principal		Rate/Return	31 March 2007 Principal	Rate/Return
Fixed Rate Funding:					
- PWLB	£16.1m			£13.9m	
- Market	£- m	£16.1m	7.79%	£- m	8.52%
Variable Rate Funding:					
- PWLB	£- m			£- m	
- Market	£0.2m	£0.2m	5.71%	£0.4m	5.79%
Total Debt		£16.3m	7.79%	£14.3m	8.52%
Investments:					
- In-house	£6.0m		5.57%	£8.2m	4.92%
- With Managers	£- m		-%	£- m	-%
Total Investments		£6.0m	5.57%	£8.2m	4.92%

2.2 Performance Measurement

2.2.1 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. Whilst investment performance criteria have been well developed and universally accepted, debt performance indicators continue to be a more problematic area with the traditional average portfolio rate of interest acting as the main guide (as incorporated in the table in paragraph 2.1).

2.3 The Strategy for 2007-08

2.3.1 The recommended treasury strategy for 2007-08 was based on our view of the rate of growth of GDP in the UK economy continuing to be steady at trend during 2007-08. Bank Rate was expected to remain steady at 5% until the final quarter of the year when it would fall to 4.75%. This was predicated on CPI being at target on the two year horizon, that wage growth was below the MPC's threshold of 4.5%, that GDP trend growth would be higher due to inward migration and that the US economy would ease in 2007. Risks to the upside would include house prices continuing to rise, wage pressures rising in response to inflationary pressures and utility prices continuing higher.

2.3.2 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 trend growth in the UK, US and EU would lead to a decrease in UK bank rate from 5.00% to 4.75% by the end of March 2008.

Longer-term interest rates – The view on longer-term fixed interest rates, 50 years, was that they would remain static around the 4.25% for the whole of the year. The 25 year rate would also remain flat around 4.50%.

2.3.3 The Adopted Treasury Strategy – The agreed strategy put to the Council/Cabinet, based upon the above forecast, was that:-

a. That the expectation for falling base rates in the future was so strong that the drawing of cheaper, shorter term funding later in the year for some of the financial year 2007-08 borrowing requirement would assist in lowering debt servicing costs. The risk was that leaving longer term borrowing to later years could eventually entail higher longer-term interest costs.

b. That the risks intrinsic to shorter term variable interest rates are such, when compared to historically low long term funding costs, that the Council will maintain a stable, longer term portfolio by drawing longer term fixed rate funding.

c. The Council operated both borrowing and investment portfolios and as a consequence was at lower risk from being impacted by a sharp, unexpected rise in short-term variable interest rates. The strategy for the year was therefore to maintain a balance of funding at short-term rates to match short-term investments thus maintaining balanced treasury risk.

2.4 The Economy

2.4.1 Shorter-term interest rates – Bank Rate started 2007-08 at 5.25% with expectations that there would be further increases in rates. This was reflected in a positive interbank money market curve. A further increase in rates to 5.5% duly occurred on 10th May 2007 but not before the Governor of the Bank of England had written a letter to the Chancellor in April explaining why CPI had risen to 1% or more above the official CPI inflation target of 2%. The Bank of England's Inflation Report issued in May showed inflation would be above target at the two year horizon. Another rise was delivered on 5th July when Bank Rate rose to 5.75% and the markets, including Sector, fully expected Bank Rate to increase again. One year interbank was priced at over 6%, GDP growth was continuing to strengthen and the housing market was still robust. The August Inflation Report showed Bank Rate needed to rise to 6% to keep inflation at target in two years time.

2.42 August, as it turned out, was the peak of interest rates as what has become known as 'the credit crunch' hit the markets and the global economy. The crunch originated in the US through the sub-prime housing market. Although originating in the US, world wide investors, particularly banks, had invested in packages of sub-prime loans, attracted by the higher yields offered. Fears arose that a large number of these investments would turn out to be worthless and this in turn would lead to bankruptcies amongst the banking sector. As a result of these fears, and the ensuing reluctance of banks to lend to each other, the Federal Reserve Bank injected $38bn of liquidity into the markets on 9th August. The ECB followed suit but the Bank of England stood on the sidelines only making cash available at a penal rate of 1% above Bank Rate. On 17th August the Federal Reserve cut interest rates by 50 bp to 5.25%. On 20th August Sector revised its interest rate view to reflect a downside risk to its forecast. The dislocation in the markets continued throughout the summer until on 14th September it was announced that the Bank of England had provided billions of pounds of financial support to Northern Rock. Northern Rock had been affected by the drying up of the wholesale money markets which provided 80% of its funding. On 17th September the Chancellor announced a Government guarantee for all deposits held at the stricken bank. A day later the Federal Reserve cut US rates by a further 50bp although oil rose to $80 a barrel and continued to climb reaching a peak, briefly, of $100pb in November. On 24th September Sector revised its interest rate forecast with 5.75% now the peak in rates. At its October meeting the MPC declined to cut Bank Rate, being concerned about the inflation outlook. UK data continued to be robust during the autumn although CPI dropped to 1.8% in September. 3 month LIBID still remained well above Bank Rate. On 31st October the Federal Reserve cut rates yet again to 4.50% and the following day they added $41bn of reserves in an attempt to free up the markets. The MPC eventually cut Bank Rate on 6th December to 5.50% as concerns about the economy and the credit crunch mounted. On 10th December both UBS and Capital Economics revised their interest rate forecasts down sharply. A day later the Federal Reserve cut rates again, this time by 25 bp.

2.43 2008 was ushered in with major fears about the global economy. Stock markets fell sharply and government bond yields fell. On 22nd January the Federal Reserve cut rates, this time by a massive 0.75bp to 3.5%, and once more on 30th January to 3%. The MPC followed suit in February cutting Bank Rate by 25 bp to 5.25%. On 18th February it was announced that the Government would nationalize Northern Rock. In late February and March the markets seized up again, forcing concerted liquidity intervention by the world's central banks, initially to little avail. The UK budget brought increased debt issuance, but little else, pushing gilt yields up sharply at the front end and driving PWLB rates up. On 14th March US investment bank Bear Stearns had to be bailed out by the Federal Reserve, culminating in a takeover by JP Morgan. The year ended with the money markets anxious and nervous and 3 month cash 75bp above bank rate.

2.4.4 Longer-term interest rates – The PWLB 45-50 year rate started the year at 4.45 and fell to a low of 4.38% in March 2008. The high point, of which there were several, for 45-50 year was 4.90% before finishing the year at 4.42%. The volatility in yields was a direct reflection of the massive turnaround in interest rate sentiment brought about by the sub-prime crisis in the US. A radical change to the PWLB rate structure was introduced by the DMO on 1st November when they moved to single basis point moves in their rates and introduced a separate repayment rate at the same time, at a level significantly below the rate at which they would lend new money.

2.5 Borrowing and Investment Rates in 2007-08

2.5.1 12-month bid rates: One year LIBID was on a rising trend until September 2007. Initially the increase was due to the interest rate outlook and the expectation that the MPC would need to increase rates to counter inflation. The sub-prime crisis then took over as lenders became nervous about lending for longer periods. The one year rate reached a level of over 6.5% in September 2007 before easing back down to just over 5.5% by the end of the calendar year. In 2008 interest rate expectations veered towards cuts in rates again and so the one year moved down to 5.1%. Following the February Bank Rate cut and Inflation Report it edged back up again to 5.4% and continued higher to 5.8% in March as interbank markets seized up again.

2.5.2 Longer-term interest rates – The PWLB 45-50 year rate started the year at 4.45% (25 year at 4.65%) and fell to a low of 4.38% in March 2008 when Cannock Chase District Council took their additional loan (25 year low was 4.45% January). The high point, of which there were several, for 45-50 year was 4.90% (25-30 year had several highs of 5.15% in June/July 2007) before finishing the year at 4.42% (25-30 year 4.60%). The volatility in yields was a direct reflection of the massive turnaround in interest rate sentiment brought about by the sub prime issue in the US. A radical change to the PWLB rate structure was introduced by the DMO on 1st November when they moved to single basis point moves in their rates and, at the same time, introduced a separate repayment rate at a level significantly below the rate at which they would lend new money.

2.6 Borrowing Outturn for 2007-08

2.6.1 As comparative performance indicators, average PWLB maturity loan interest rates for 2006-07 were:-

1 year	5.18%
9.5 - 10 year	5.07%*
25 - 30 year	4.74%*
49.5 - 50 year	4.60%*
1 month GBR variable	5.71%

* due to the change in banding of PWLB rates as from 1.11.07, some interpolations has had to be used to calculate some average figures for 2007-08.

2.6.2 Debt Performance – As highlighted in paragraph 2.1 above, the average debt portfolio interest rate has moved over the course of the year from 8.52% to 7.79%. The approach during the year was to fund borrowing from surplus cash except at the end of the year when this seemed to be becoming unfeasible due to fall off in Capital Receipts

2.7 Compliance with Treasury Limits

2.7.1 During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Policy Statement and annual Treasury Strategy Statement. The outturn for the Prudential Indicators is shown in Annex 1.

2.8 Investment Outturn for 2007-08

2.8.1 Internally Managed Investments – The Council manages its 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 364 days, dependent on the Council's cash flows, its interest rate view and the interest rates on offer.

2.8.2 Investment Strategy – The expected short-term investment strategy for in-house managed funds was that the Council viewed the market's expectation for base rates as too low, and that short term rates would rise during the year. Investments were, accordingly, kept short, with a view to enabling returns to be compounded more frequently. At the start of the year our treasury advisors, Sector, had forecast that interest rates would increase due to concerns about rising inflationary pressures. These concerns grew further and correspondingly caused the forecast for interest rates to rise in order to counter this problem. The Bank of England duly reacted to the inflation rate threat with two 25bp increases in Bank Rate by August with market expectation that one further increase of 0.25% to 6% would be required.

2.8.3 However, in August the US sub-prime mortgage disaster exploded and stopped any further increase in Bank Rate above 5.75%. This crisis generated even greater volatility and fear that gave rise to a credit squeeze resulting in market rates rising to over 100 basis points above Bank Rate as banks introduced credit spreads. The markets became dislocated from the fundamentals of global economics and became dominated by the vagaries of financial markets in turmoil.

2.8.4 Throughout the year Sector advised to take advantage of the rising rates and invest in the one year period as and when previous investments matured. On occasions the option to place on call, or short dated investment, was taken in order to time investment successfully at better levels and to develop a spread of maturities.

2.8.5 Investment Outturn for 2007-08 – Detailed below is the result of the investment strategy undertaken by the Council.

	Average Investment	Rate of Return (gross of fees)	Rate of Return (net of fees)	Benchmark Return
Internally Managed	£10.964m	5.93%	N/A	5.70%
Externally Managed	-	-	-	-

No institutions in which investments were made had any difficulty in repaying investments and interest in full during the year.

The Council had invested £1,500,000 with Northern Rock at the time of their nationalization. The funds were guaranteed by the Bank of England and full repayment was received on the appropriate date.

2.9 Debt Rescheduling

2.9.1 No opportunity for debt rescheduling presented itself during the year and none was therefore undertaken.

2.10 Other Issues

2.10.1 There were no other issues of note for Treasury to deal with in 2007-08

Section 3

3. Contribution to CHASE

3.1 As a major contributor to attaining the Budget requirements Treasury Management enables the Council to fulfil all aspects of CHASE.

Section 4

4. Section 17 (Crime Prevention) Implications

4.1 There are no Section 17 implications arising from this report.

Section 5

5. Human Rights Act Implications

5.1 There are no identified implications in respect of the Human Rights Act 1998 arising from this report.

Section 6

6. Data Protection Act Implications

6.1 There are no implications arising from this report.

Section 7

7. Risk Management Implications

7.1 Treasury Management is a high risk area due to the large amounts of money dealt with on a daily basis. However, the Council has a Treasury Policy and Strategy in place which is approved each year for the following 12 months. The Council also has advice on investment and lending from the leading company in the field and has instituted a strict control and delegation of duties regime which reduces all risks to a minimum.

Section 8

8. Legal Implications

8.1 The legal implications are set out throughout the report..

Section 9

9. Financial Implications

9.1 There are no direct financial implications arising from this report.

Section 10

10. Human Resource Implications

10.1 There are no Human Resource Implications arising from this report.

Section 11

11. Conclusions

11.1 Treasury Management during the year has been carried out in line with the previously approved Treasury Management Strategy and Policy taking advice from our treasury advisors. No additional borrowing has been required during the year while both performance indicator returns and budgeted investment income have been exceeded.

Section 12

List of Background Papers

Statement by the Leader of the Council 2007-08

ANNEX 1

Prudential Indicators

	2006-07 Actual	2007-08 Projected	2007-08 Actual	2008-09 Estimated	2009-10 Estimated	2010-11 Estimated
Affordability						
Ratio Financing Costs to Net Revenue Stream						
General Fund	-5.61%	-5.56%	-6.20%	-8.82%	-8.07%	-6.31%
HRA	9.90%	9.78%	10.34%	10.29%	10.78%	11.27%
Incremental impact of capital investment decisions on Council Tax	0	0	0	0	0	0
Incremental impact of capital investment decisions on average weekly housing rents	0	0	0	0	0	0
Capital Expenditure	£m	£m	£m	£m	£m	£m
Total Capital Expenditure (including external funding)						
General Fund	1.383	4.189	3.989	14.526	7.502	13.100
HRA	8.243	8.971	8.436	8.775	8.590	6.603
Capital Financing Requirement as at 31March						
General Fund	5.839	7.415	7.557	7.489	7.315	7.142
HRA	18.208	18.579	18.586	18.942	19.305	19.668
External Debt						
Authorised Limit	19.117	20.131	20.131	20.962	21.382	21.802
Operational Boundary	17.393	18.407	18.407	19.238	19.658	20.078
External Debt as at 31 March	14.288	13.786	16.286	13.239	12.955	9.789
Net Borrowing (ie less Investments) as at 31 March	5.617	9.252	10.265	-1.797	3.563	12.449

Prudence

Net Borrowing and the Capital Finance Requirement — Net Borrowing is not expected to exceed the total of the Capital Financing Requirement (except in the short term)

Interest Rate Exposure

	2007-08 Projected	2007-08 Actual	2008-09 Estimated	2009-10 Estimated	2010-11 Estimated
Upper Limit Fixed					
Borrowing	100%	100%	100%	100%	100%
Investment	50%	50%	50%	50%	50%
Upper Limit Variable					
Borrowing	10%	10%	10%	10%	10%
Investment	100%	100%	100%	100%	100%

Maturity Structure Of Borrowing	Upper Limit	Lower Limit
Under 12 months	2.52%	0%
12 months to 24 months	2.77%	0%
24 months to 5 years	26.38%	0%
5 years to 10 years	1.59%	0%
10 years and above	66.74%	0%

Glossary of Terms

bp – base points. The Base Rate is the rate used by the Bank of England for its official operations in the Sterling Money Markets.

CPI – Consumer Price Index. A calculated index showing how the average cost of consumer prices changes over time.

DMO – Debt Management Office. An executive agency of HM Treasury, responsible for debt and cash management for the UK government, lending to local authorities and managing certain public sector funds.

ECB – European Central Bank. This bank determines the policy with regard to the euro. The ECB's primary task is to maintain the purchasing power of the euro and thereby the price stability in the euro countries.

GDP – Gross Domestic Product. A measure of the total domestic economic activity. It is the sum of all incomes earned by the production of goods and services on UK economic territory.

MPC – Monetary Policy Committee (of the Bank of England). Meets monthly to discuss and alter interest rates.

LIBID – London Inter Bank Bid Rate. Banks in the City of London tend to lend and borrow money from one another in the wholesale money markets. The rate at which a bank is willing to borrow money is called the London Inter Bank Bid Rate.

PWLB – Public Works Loan Board. A central government agency which provides long and medium-term loans to local authorities at interest rates only slightly higher than those at which the government itself can borrow. Local authorities are able to borrow a proportion of their requirements to finance capital spending from this source.

UBS – Union Bank of Switzerland. World leaders in financial services.