REPORT TO:	**FINANCE AND MANAGEMENT COMMITTEE (SPECIAL – FINAL ACCOUNTS)**	**AGENDA ITEM: 6**
DATE OF MEETING:	**29th JUNE 2010**	**CATEGORY: DELEGATED**
REPORT FROM:	**DIRECTOR OF CORPORATE SERVICES**	**OPEN**
MEMBERS' CONTACT POINT:	**KEVIN STACKHOUSE (595811)**	**DOC**: u/ks/treasury management/annualreports/2008-2009
SUBJECT:	**TREASURY MANAGEMENT ANNUAL REPORT 2009/10**	**REF:**
WARD (S) AFFECTED:	**ALL**	**TERMS OF REFERENCE: FM 08**

1.0 Recommendations

1.1 That the Treasury Management Annual Report for 2009/10 is considered and approved.

1.2 To note the Treasury Management Stewardship Report and Prudential Indicators for 2009/10 (as detailed in Appendix1) and that the Council complied fully with all requirements.

1.3 That the Statement on the Minimum Revenue Provision for 2009/10 is recommended to Council for approval.

2.0 Purpose of Report

2.1 To detail the Council's actual borrowing and lending for 2009/10 compared to the approved strategy, including performance against its Prudential Indicators. This is in accordance with the Local Government Act 2003 and associated regulations.

3.0 Executive Summary

3.1 The Council's borrowing and investment strategy for the year required that its cash flow requirements were managed through short-term borrowings and bank deposits. Overall, the Council's cash flow remained positive throughout the year as forecast.

3.2 However, some short-term borrowing was undertaken towards the end of the financial year due to a reduction in cash compared to that anticipated. This situation is not unique during February and March but was greater than anticipated for 2009/10.

3.3 This was due to a combination of increased housing benefit payments and capital expenditure to meet project milestones, especially for the town centre improvements project. However, this is a timing issue as grants/subsidy to pay for this expenditure will be reclaimed over the first quarter of 2010/11.

3.4 As financial monitoring reports throughout the year highlighted, 2009/10 (like 2008/09) was again an exceptional year due to the historical low level of interest rates and the nervousness of financial markets.

3.5 The main Bank of England Base Rate remained at 0.5% throughout the year and this severely limited the amount of interest earned on short term investments and bank deposits.

3.6 In undertaking its treasury management functions during the year, the Council managed its activities within its prudential indicators and approved lending policy.

4.0 <u>Detail</u>

Borrowing During 2009/10

4.1 The Council's approved borrowing strategy for 2009/10 was:

- To manage its cash flow requirements through short-term borrowings and bank deposits

- That in accordance with capital investment requirements, no longer-term borrowing is undertaken in the year.

- That the one remaining Money Market loan of £1m be repaid should the Lender invoke their option to increase the interest rate.

The Council's Cash Flow During 2009/10

4.2 The Council's cash flow can fluctuate on a daily basis depending on the timing of income and expenditure.

4.3 At certain times of the year, the Council may need to borrow to cover shortfalls on a temporary basis, whilst when cash flow is positive any surplus funds are invested on a temporary basis.

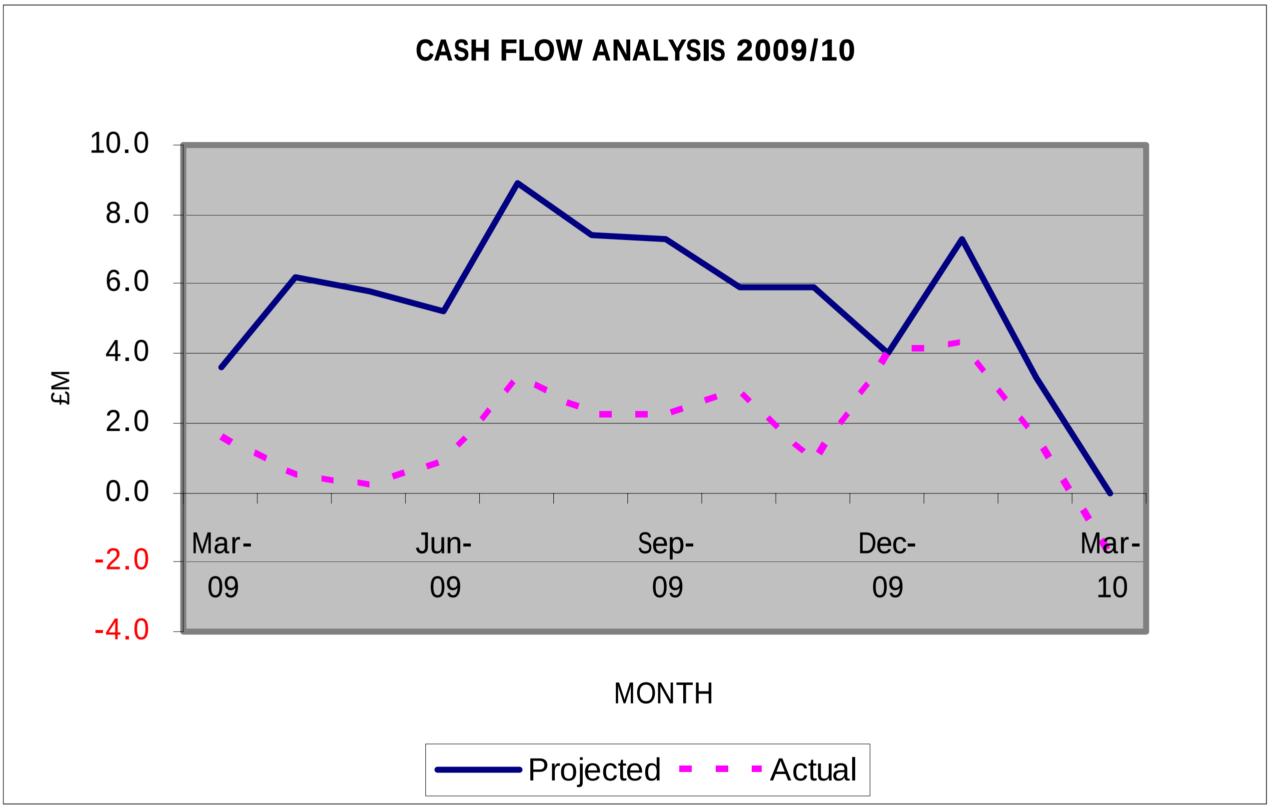
4.4 For several years the Council has not undertaken any form of new long-term borrowing having financed its capital expenditure from other sources such as government grants, external funding and from its own capital receipts. In addition, except for one money market loan, the Council is effectively debt free having repaid its remaining Government debt back in March 2004.

4.5 The Council effectively invests its reserves over the year and this generates interest for the General Fund and Housing Revenue Accounts. In addition, the Council is generally able to collect its main income in the form of council tax and business rates before distributing it. This is invested on a short-term basis and generates a return for the Council.

4.6 However, as was the case for 2009/10, a significant increase in housing benefit payments and capital expenditure at the year-end can have the opposite effect as the Council reclaims the outlay after the event. If this is greater than the Council had planned, it will cause a short-term borrowing requirement to cover a shortfall in cash.

4.7 Overall, the Council continued to benefit from a positive cash flow position throughout 2009/10. However, given the extremely low level of interest rates, the financial benefit in the form of interest earned was significantly reduced compared to previous years.

4.8 The Council's cash flow during 2009/10 with a comparison to that originally projected is shown in the following graph. In general, the actual pattern of cash flow followed that projected. However, the amount of funds available was generally lower than estimated,



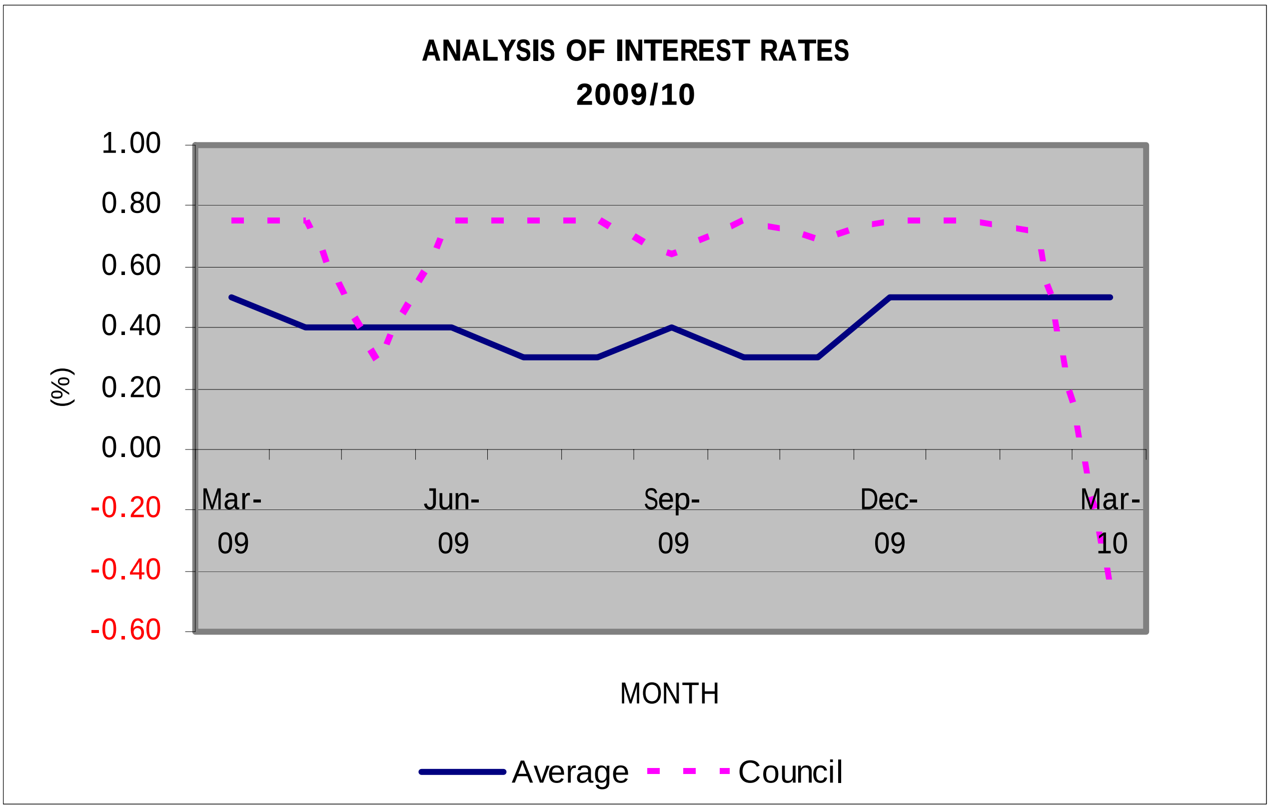
Interest Rates

4.9 Back in January 2009, the Council's projections assumed interest rates averaging 2.5% in 2000/10 in accordance with the prevailing market rate and economic predictions guiding its movement over the coming 12 months. Consequently, the budget for investment income was based on this rate.

4.10 Although the main bank base rate as set by the Bank of England was reduced on 3 successive occasions between January and March 2009, from 2% to 0.5%, it was expected at that time, that it would again increase during 2009/10. However, the rate has remained at 0.5% from 5th March 2009 and indeed is now forecast to do so throughout 2010.

4.11 It soon became clear that this would have an effect on the Council's level of interest income in its budget for 2009/10 and following a review of the Medium-Term Financial Plan in September 2009, the projected income was reduced sharply from £175,000 to £30,000.

4.12 This was based on achieving an average rate of 0.75%, a quarter of a percentage point above the main base rate of 0.5%. The performance during the year is shown in the following graph.



4.13 The above graph shows that the Council's achieved a rate that was generally in line with 0.75% for most of the year, out-turning at 0.72%. The average rate for comparison purposes, relates to a market average as measured by a 7-day money market rate, this being the benchmark used by the Council in its investment strategy.

4.14 The Council's rate for the year at 0.72% was higher than the market (0.39%), although clearly on these rates, the financial benefit was substantially less compared to recent years.

4.15 The negative rate at the year end reflects that the Council needed to undertake some short-term borrowing (as highlighted previously).

Temporary Borrowings

4.16 Besides this short-term borrowing, the Council holds money on deposit for Parish Councils. This money is classed as temporary as it can be recalled on immediate notice.

4.17 The Council pays 1% below the prevailing base rate. As this was 0.5% throughout the year, no payments were made on the outstanding principal of £184,000.

Budgetary Implications

4.18 The level of interest actually received and paid is built into the General Fund Revenue Account. A proportion of this is recharged into the Housing Revenue Account under a prescribed calculation.

4.19 The actual interest received compared to that included in the approved budget is summarised below.

CASH FLOW INTEREST 2009/10	**BUDGET £**	**ACTUAL £**
Overall interest received from money on deposit	30,000	23,756
Less – Interest payments on temporary borrowings	(1,315)	(102)
Net Interest Received	**28,685**	**23,654**

4.20 The net effect is that overall interest received was lower compared to that budgeted by approximately £5,000, in line with that reported to the Committee in February 2010 as part of the quarterly monitoring report.

Other Interest Paid and Received

4.21 In addition, the Council paid and received other interest during the year as set out in the following table. Overall, the Council's interest liability was lower compared to that budgeted, which after adjusting for the HRA's share, is a benefit to the General Fund.

Summary of Interest Payment and Receipts 2009/10	**Budget (£)**	**Actual (£)**	**Variance (£)**
Money Market Loan	48,750	49,418	668
Temporary Loans	1,315	102	(1,213)
Bank Interest	1,400	927	(473)
Covenants	101,050	100,068	(982)
Transferred Debt	19,600	4,457	(15,143)
Interest Received on Deposits	(30,000)	(23,686)	6,314
Other Interest Received	0	(4,298)	(4,298)
Interest Recharged to the HRA	(97,284)	(97,896)	(612)
Net Interest Payable	**44,831**	**29,092**	**(15,739)**

Money Market Debt

4.22 The only long-term debt still remaining is one money market loan for £1m. As the above table shows, this costs approximately £49,000 per year in interest charges at a fixed rate of 4.875%. It is due to mature in 2032.

4.23 Potentially, there is a break clause. The lender has the option of reviewing the interest rate at any time and increasing it if they so wish. However, the Council then has the option of rejecting this and can instead choose to repay without incurring any penalty.

4.24 In setting the borrowing strategy for 2009/10, it was it was resolved that should the lender exercise their option to increase the interest rate, then the loan should be repaid at that time from money set-aside to do so.

4.25 The lender did not invoke their option during the year and the situation will be kept under review. The same strategy regarding this loan was adopted as part of the treasury management policy for 2010/11.

Investments 2009/10

4.26 The Council does not have any long-term investments, but the Council is required to maintain an investment strategy covering short-term investments such as the deposit of surplus funds.

4.27 The overall strategy in the year was to effectively invest surplus funds to meet cash flow requirements within the year. In addition, there was no proposal to enter into longer term and externally managed funds.

4.28 The Council invests surplus funds in accordance with an approved policy and associated lending list. This is summarised in the following table.

Institution	Limit
Specified Investments	
• UK Debt Management Office (DMO)	£10m
• Local, Police, Fire and Parish Authorities	£5m
• Other Bodies with a High Credit Rating of F1+/AA-	£7.5m
Non-Specified Investments	
• F1/AA Rated Bodies – First Call	£2m
• F1/A Rated Bodies – Second Call	£1m
• F2/A Rated Bodies – Third Call	£0.25m

Definition of Credit Ratings

4.29 The long-term rating is based on an investment grade categorised by “Fitch” on the following scale:

- AAA: the best quality companies, reliable and stable
- AA: quality companies, a bit higher risk than AAA
- A: economic situation can affect finance
- BBB: medium class companies which are satisfactory at the moment.

4.30 Intermediate modifiers are also used for each category between AAA and BBB (i.e. AA+, AA, AA-, A+, A, A-, etc.).

4.31 Short-term credit ratings indicate the potential level of default within a 12-month period, based on the following scale.

- F1+: best quality grade, indicating exceptionally strong capacity to meet financial commitments.
- F1: best grade, indicating strong capacity to financial commitments.
- F2: good quality grade with satisfactory capacity to financial commitments.

4.32 The scale then falls from F3 to B, then C and finally down to D, which indicates the institution is likely to, or as failed to meet its financial commitments.

General Policy

4.33 As approved, priority is given to specified investments in any investment decision. The length of investment is made in accordance with overall cash flow requirements.

4.34 The Council's policy is to seek investments with those institutions graded at least AA and F1+.

4.35 A substantial amount of available funds are lodged with the Council's own bank, together other major UK banks and building societies whose credit ratings fall within the approved policy.

4.36 All deposits made in the year were in accordance with the approved lending list and were all Specified Investments. The Council has no investments tied up in the Icelandic banking system.

Performance Indicators

4.37 As indicated earlier, the main indicator is for the return on short-term investments to average over the year, **the local authority 7-Day Rate,** a standard measure of performance. The Council's performance for 2009/10 (with a comparison to recent years) is shown in the following table.

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
7-Day Rate (target)	3.51%	4.47%	4.44%	4.82%	5.61%	3.57%	0.39%
Actual Rate	3.55%	4.63%	4.50%	4.86%	5.81%	4.38%	0.72%

Prudential Indicators

4.38 Under the Code of Practice for Capital Finance, the Council must set and regularly monitor Prudential Indicators. These indicators are designed to measure and place controls over the level of borrowing and capital financing during the year.

4.39 They are set following the annual budget round where the Section 151 (Chief Finance) Officer is required to provide an assessment of these indicators and the implications for the Council's spending plans and overall financial position.

4.40 The prudential system provides the flexibility for these indicators to be changed depending on local circumstances. It is the responsibility of the Section 151 Officer to advice the Council accordingly.

4.41 The actual indicators for 2009/10, together with further details on treasury management activity are detailed in **Appendix 1.** There were no major variations to the approved indicators during the year and the Council operated within its capital budgets and limits for external borrowing at all times.

Minimum Revenue Provision (MRP) - Background

4.42 Local authorities are required each year to <u>set-aside</u> some of their revenues as a provision to repay any borrowings or other credit (shorthand this is technically called "debt"). This set-aside is known as MRP and is a charge on the Council's General Fund.

4.43 This requirement has existed for many years and is designed to ensure that authorities, prudently, make provision to meet their credit liabilities into the future. With effect from 2007/08, the regulations governing this were amended.

4.44 This was to ensure that authorities continue to make a sufficient and prudent provision in their accounts, in particular where they have made any unsupported borrowing under the (then) new Prudential System.

4.45 Under the previous regulations, the calculation of MRP was effectively a set formula, although there was provision to increase this amount if an authority so wished. Regulations now effectively force authorities to undertake their own calculation under 1 of 4 options, depending on local circumstances.

4.46 It is the responsibility of the Section 151 Officer to advise on the treatment of MRP and to recommend a suitable policy for adoption. Consequently, authorities are also required to prepare an annual statement on making a MRP.

The Calculation

4.47 MRP traditionally had been calculated (at a rate of 4%) based on an <u>assumed</u> historical level of debt. This assumed level is in effect set by central government in their annual financial settlement. It is based on previous "permissions to borrow."

4.48 These permissions are backed by support towards servicing the associated debt (including MRP) through revenue support grant.

4.49 It is important to note however, that over time, the assumed level will not in practice, usually match the actual level of debt outstanding at an authority; this was the case for South Derbyshire.

4.50 This is because actual repayments and new borrowing will have been undertaken over different time scales and at varying interest rates to suit an authority's borrowing requirement, their cash flow and prevailing money market conditions. Associated borrowing may not have even been undertaken, with authorities wishing or being able to finance capital expenditure from other sources.

4.51 In addition, debt restructures will also have created a difference between the assumed level and actual debt outstanding at any one time.

The 4 Options

4.52 The calculation is now designed to ensure that a "prudent" provision is made for debt repayment. The 4 options are as follows:

- **Option 1** - For debt that is supported by the Government through the grant system, authorities may continue to use the formula in current regulations (4%), since revenue support grant is calculated on that basis. Technically however, this option has now been revoked, but has been maintained temporarily as a transitional measure for capital expenditure incurred before 1st April 2008.

- **Option 2** – A simplified method of option 1 that reflects supported debt based on an authority's capital financing requirement. This method should have been in place since 2004 when the Prudential System was first introduced.

- **Option 3** – The method to use for new borrowing under the Prudential System for which no Government support is given, MRP being based on the life of the asset being purchased.

- **Option 4** – As above, but MRP relates to the depreciation charge on the asset purchased.

Effect on South Derbyshire

4.53 The Council is operating under Option 2. Technically, the Council has been debt free under these regulations since 2004 (having repaid its Government borrowings). In addition, it has not entered into any new borrowing in recent years to finance its capital expenditure. Therefore, similar to the previous 2 years, the following statement is recommended for adoption.

Council Statement on MRP

4.54 The Council still has an assumed level of debt (or capital financing requirement) that is being subsidised through grant. Therefore, given no actual debt outstanding (other than the £1m money market loan) together with no unsupported borrowing, it is recommended that "prudence" be best achieved by continuing to provide a MRP under **Option 2**.

4.55 It is recommended that this policy be endorsed for 2009/10 and adopted for 2010/11. It will be kept under review depending on the Council's future capital expenditure and financing requirements.

4.56 Any proposed changes will be reported as necessary to this Committee for consideration and recommendation to Council. The impact on the MRP will be considered in any decision to enter into any borrowing under the Prudential System.

5.0 Financial Implications

5.1 As detailed in the report. The changes to the MRP and the proposed Statement, has no additional financial implications for the Council at this stage as the budgets in the Medium Term Financial Plan have been calculated to reflect this approach.

6.0 Corporate Implications

6.1 None directly.

7.0 Community Implications

7.1 None directly.

8.0 Background Papers

8.1 Local Government Act 2003 and associated Statutory Instruments detailing regulations under the Local Authorities (Capital Finance and Accounting England Regulations) of 2003, 2006 and 2008.

ANNUAL REPORT ON THE TREASURY MANAGEMENT SERVICE AND PRUDENTIAL INDICATORS 2009/10

1.0 Introduction

1.1 The annual treasury report summarises:

- Confirmation of compliance with treasury limits and Prudential Indicators
- Capital activity for the year and how this was financed
- Impact on the Council's indebtedness for capital purposes
- The Council's overall treasury position
- The reporting of the required Prudential Indicators
- Summary of interest rate movements in the year
- Debt and investment activity

2.0 Regulatory Framework, Risk and Performance

2.1 The Council's treasury management activities are regulated by a variety of professional codes, statutes and guidance. These include the Local Government Act 2003, which provides the powers to borrow and invest as well as providing controls and limits on this activity.

2.2 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 that may be undertaken; no restrictions were made in 2009/10.

2.3 Amended regulations develop the controls and powers within the Act and require the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities. It 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.

2.4 Under the Act the Government have also issued Investment Guidance to structure and regulate the Council's investment activities.

2.5 The Council has complied with all of the above 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.

2.6 There is little risk of volatility of costs for the current debt as the interest rate is fixed.

2.7 Shorter-term interest rates and likely movements in these rates in the future, predominantly determine the Council's investment return. These returns can therefore be volatile and whilst the risk of loss of principal is minimal through the annual investment strategy, accurately forecasting future returns can be difficult.

3.0 The Council's Capital Expenditure and Financing 2009/10

3.1 The Council undertakes capital expenditure on long-term assets. These activities may either be financed through revenue, capital receipts, capital grants, or borrowing.

3.2 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.

3.3 The actual capital expenditure is a key prudential indicator. The table below shows how the capital expenditure was financed.

Capital Expenditure and Financing			
	2008/09 Actual £000	**2009/10 Estimate £000**	**2009/10 Actual £000**
Capital Expenditure			
General Fund	3,591	5,684	4,078
HRA	2,957	2,429	2,294
Total Capital Expenditure	**6,548**	**8,113**	**6,372**
Financed by:			
Capital receipts	1,070	1,973	1,670
Capital grants	2,770	3,976	2,667
Capital reserves	2,609	1,959	1,763
Revenue Contributions	99	205	272
Net Financing Need for the Year	**0**	**0**	**0**

4.0 The Council's Overall Borrowing Need

4.1 The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). The CFR is a measure of the Council's underlying need to borrow for capital investment and is based on the value of its assets contained in the Balance Sheet.

4.2 The capital expenditure that has not been immediately paid for will increase the CFR through additional borrowing. The Council is required to pay off an element of the accumulated General Fund CFR each year through a revenue charge called the Minimum Revenue Provision (MRP).

4.3 As the Council has no unsupported borrowing, MRP will continue to be based upon the assumed level of debt on introduction of the Prudential Code in 2004.

4.4 The Council's CFR for the year is shown below.

Capital Financing Requirement (CFR)			
	2008/9 Actual £000	**2009/10 Estimated £000**	**2009/10 Actual £000**
Net financing need for the year	0	0	0
MRP/VRP and other financing movements	328	315	315
Movement in CFR	**328**	**315**	**315**
CFR – General Fund	7,435	7,138	7,138
CFR – Housing	5,495	5,477	5,477
Total CFR	**12,930**	**12,615**	**12,615**
Movement in CFR	**328**	**315**	**315**

5.0 Treasury Position at 31 March 2010

5.1 The treasury position at 31 March 2010 compared with the previous year is shown in the following table.

Treasury Position	31 March 2009		31 March 2010	
	Principal £000	**Average Rate %**	**Principal £000**	**Average Rate %**
Fixed Interest Rate Debt	1,000	4,88	4,000	5.33
Variable Interest Rate Debt	274	2.65	184	0
Total Debt	**1,274**		**4,184**	
Fixed Interest Investments	0	0	0	0
Variable Interest Investments	0	0	1,009	0.75
Total Investments	**0**		**1,009**	
Net Borrowing Position	**1,274**		**3,175**	

5.2 At 31 March 2010 the Council's debt was just under £4.2m (compared with £1.3m at 31 March 2009). The figure at 31 March 2010 includes the money market loan for £1m, temporary borrowings of £3m and £0.2m deposited by Parish Councils. Investments totaled £1m (compared with nil at 31 March 2009).

5.3 The short term borrowing of £3m was taken out on 16 March 2010 in order to meet cash flow commitments. This situation had arisen because of timing differences between making payments to contractors for major capital schemes, together with reimbursement of this expenditure from funding partners and for housing benefit payments.

5.4 In previous years, the Council had sufficient surplus cash to meet similar commitments without the need for short term borrowing. However, the on-going effects of the current economic situation has resulted in significantly less cash being available to help manage the Council's overall cash flow position. This loan was repaid on 4 May 2010.

6.0 Prudential Indicators and Compliance Issues

6.1 The prudential indicators provide an overview and specific limits on treasury activity. These are detailed below.

a) **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 have not exceeded the CFR for 2009/10, plus the expected changes to the CFR over 2010/11 and 2011/12. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

Capital Financing Requirement (CFR)			
	2008/9 Actual £000	**2009/10 Estimated £000**	**2009/10 Actual £000**
Gross Borrowing	1,274	1,184	4,184
Less: Investments	0	0	1,009
Net Borrowing	**1,274**	**1,184**	**3,175**
CFR	**12,930**	**12,615**	**12,615**

b) **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 2009/10 the Council has maintained gross borrowing within its Authorised Limit.

c) **The Operational Boundary** – is based on the expected maximum external debt (as described above) during the course of the year, but it is not a limit. It is designed to help the Head of Finance manage treasury activity on a daily basis and acts as an early warning sign of any potential issues.

d) **Actual Financing Costs as a Proportion of Net Revenue Stream** – identifies the trend in the cost of capital (borrowing and other long-term obligation costs net of investment income) against the net revenue stream.

Prudential Limits and Operational Boundaries	2009/10 Actual £000
Authorised Limit	25,287
Maximum Gross Borrowing Position	4,184
Operational Boundary	12,650
Average Gross Borrowing Position	2,729
Minimum Gross Borrowing Position	1,274
Financing Costs as a Proportion of Net Revenue Stream:	
• Council Tax	1.5%
• Rent	2.5%

7.0 Economic Background

7.1 Treasury activity is directed by both current market interest rates and expectations of future movements, which are influenced by inflation and demand/supply considerations.

7.2 During 2009/10 the Bank of England kept short and long term interest rates low. Of particular concern were the effects of the recession on the money markets. This impacted on the Council's ability to generate income through investment of surplus funds.

8.0 The Strategy Agreed for 2009/10

8.1 The strategy approved for 2009/10 expected that the uncertainty over the money markets increased the risk associated with treasury activity. As a result the Council maintained its general lending policy of giving priority to security and liquidity over yield.

9.0 Actual Debt Management Activity for 2009/10

9.1 There were no loans drawn down to finance capital spend or maturing debt. Loans repaid during the year equated to £90k. These related to sums deposited by Parish Councils.

10.0 Investment Position

10.1 The Council's investment policy is governed by Government Guidance, which has been implemented in the annual Investment Strategy, approved by Finance and Management Committee on 17 February 2009. The investment activity during the year conformed to the approved strategy and the Council had no liquidity difficulties.

10.2 The Council's longer-term cash balances comprise primarily revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources are shown in the following table which meets the expectations of the budget.

	31 March 2010 £000	31 March 2009 £000
Balances	5,641	5,531
Earmarked Reserves	1,203	883
Usable Capital Receipts	1,238	2,769
Total	**8,082**	**9,183**

10.3 The low bank base rate has continued to have a detrimental impact on the Council's investment returns. The Council maintained an average balance of £3.1m for the financial year 2009/10 and received an average return of 0.72%. This was 0.33% higher than the comparable performance indicator for the average 7-day LIBID rate of 0.39%.

10.4 Investment interest received during the year was approximately £23,000 compared to a revised budget of £30,000. However, this budget was revised down from that originally set in February 2009 at £175,000.

11.0 Performance Indicators for 2009/10

11.1 The performance indicator of securing investment returns above the average 7-day LIBID rate was set. As indicated above, the performance was 0.39% higher than the target rate.