

**Manchester City Council  
Report for Resolution**

**Report To:**           **Audit Committee – 3 December 2009**

**Subject:**           **Treasury Management Interim Report 2009-10**

**Report of:**       **City Treasurer**

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**Purpose**

To report the Treasury Management activities of the Council during the first six months of 2009-10.

**Recommendations**

The Audit Committee is asked to note the report.

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**Wards Affected:**

Not Applicable

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**Background documents (available for public inspection):**

Treasury Management Strategy Statement and Borrowing Limits and Annual Investment Strategy Report 2008/09 (Executive Committee 11 February 2009)

Accounting and Financial records held in room 102.

## **1 Introduction and Background**

- 1.1 Treasury Management in Local Government is regulated by the CIPFA Code of Practice on Treasury Management in Local Authorities. The City Council has adopted the Code and complies with its requirements. A primary requirement of the Code is the formulation and agreement by full Council of a Treasury Policy Statement which sets out Council, Committee and Chief Financial Officer responsibilities, and delegation and reporting arrangements. This was updated and approved by the Council on 8 October 2003.
- 1.2 CIPFA issued an interim Treasury Management guidance document in March 2009, highlighting Best Practice recommendations for Local Authorities to follow. The document suggests that members should be informed of Treasury Management activities at least twice yearly. This report therefore ensures this Council is embracing Best Practice in accordance with CIPFA's recommendations. It is expected that CIPFA will issue an updated Treasury Management Code of Practice in the autumn of 2009, following consultation with Local Authorities during the summer. Treasury Management in this context is defined as:

“The management of the local authority's cash flows, its borrowings and its investments, the effective control of the risks associated with those activities, and the pursuit of the optimum performance or return consistent with those risks”.

- 1.3 This interim report covers:

The Council's portfolio position as at 30<sup>th</sup> Sept 2009  
A review of Economic conditions  
External borrowing  
Compliance with treasury limits and Prudential Indicators  
Temporary borrowing & Investment Outturn

## **2 Current Portfolio Position**

- 2.1 The last year has seen an interest rate differential between the cost of long term debt (4% to 4.5%) and the return available from short term investments (Under 1%) which led to the council following a strategy of running down investments and borrowing internally (using cash backed reserves). As well as the a cost of carry (paying out more interest on long term borrowing than can be earned from short term investing), there is also a difficulty in finding suitable organisations to lend surplus cash to as fewer of them meet our criteria since the banking crisis.
- 2.2 As outlined in the approved Treasury Management Strategy for 2009/10 there was a need to undertake some permanent borrowing in 2009/10 to fund the capital programme and to replace some of the internal funds. Some of this borrowing has now been taken however the policy remains to keep cash low and minimise temporary investments.

2.3 The Council's debt position at the beginning and middle of year was as follows:

Loan Type	31 March 2009		30 Sept 2009	
	Principal £m	Average Rate %	Principal £m	Average Rate %
PWLB	100.3	8.87	56.1	4.68
Temporary Borrowing	1.7	0.43	12.8	0.30
Market Loans	549.6	4.89	549.6	4.89
Stock	8.2	3.36	8.2	3.36
Special (ITA)	22.9	0.50	0.5	0.50
<b>Gross Total</b>	<b>682.7</b>	<b>5.30</b>	<b>627.5</b>	<b>4.75</b>
Temporary Deposits	(6.2)	0.45	(0.7)	0.69
<b>Net Total</b>	<b>676.5</b>	<b>5.34</b>	<b>626.8</b>	<b>4.76</b>

2.4 The table above shows that the average rate of interest paid has decreased over the course of the year, from 5.34% to 4.76%. On 30<sup>th</sup> March the East Manchester LSVT took place which led to the DCLG repaying £94.1m of our PWLB debt on 2<sup>nd</sup> April 09, with an average interest rate of 8.87%. £50M of new PWLB debt has since been taken on at much lower rates as outlined below. The temporary borrowing and deposit figures fluctuate daily to meet the daily cashflow requirements of the council. The temporary figures in the table above are therefore only a snapshot at a particular point in time.

2.5 A further £50m of PWLB borrowing has been taken after 30th September

### 3 Review of Economic Conditions April to September 2009

3.1 In September the bank of England left the key lending rate at a record low of 5% for the 6<sup>th</sup> month running. Under the quantitative easing programme new money has been injected into the economy which seems to have been successful in improving liquidity in the financial markets but has had limited impact on the real economy. Many banks are still reluctant to lend which means there are not as many opportunities for the council to borrow from the market as there was previously. Appendix 1 provides a more detailed review of the recent economic situation.

### 4 External Borrowing in the first half of 2009-10

4.1 PWLB interest rates have fluctuated across the first 6 months of the year, gradually decreasing during the second quarter across all bands as illustrated in the table and below and the graph at Appendix 2.

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.68	2.47	3.30	4.19	4.20
Date	16/09/2009	02/04/2009	02/04/2009	01/09/2009	18/08/2009
High	1.2	3.29	4.15	4.77	4.85
Date	09/06/2009	28/07/2009	24/07/2009	12/06/2009	02/06/2009
Average	0.95	2.89	3.80	4.49	4.55

4.2 Due to the overall financial position as outlined in paragraph 2.1 and the underlying need to borrow for capital purposes, new external borrowing of £50m was undertaken in September 2009 from the PWLB with durations of 20 to 25 years.

4.3 The rates at which the borrowing took place are shown in the table below and marked on the graph at Appendix 2. The rates achieved were between 4.14% and 4.21% close to the lowest points so far this year, (current equivalent rates are 4.32%).

	Start Date	Maturity (Years)	Amount (£M)	Interest Rate
A	02/09/2009	20	20	4.14%
B	02/09/2009	25	10	4.21%
C	18/09/2009	21.5	10	4.16%
D	18/09/2009	24	10	4.18%

## 5 Compliance with Treasury Limits

5.1 During the first half of the financial year, the Council operated within the treasury limits and Prudential Indicators set out in the Treasury Management Strategy Statement. Performance against these targets is shown in Appendix 3.

## 6 Investment Strategy for 2009-10

6.1 The Treasury Management Strategy Statement (TMSS) for 2009/10 was approved by Council on 11<sup>th</sup> February 2009. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as (a) the security of capital and (b) liquidity of investments.

6.2 In order to achieve a higher level of security the City Treasurer introduced the following measures:

- Investments to be restricted to UK banks, building societies, local authorities and government institutions.
- Diversify the investment portfolio into more secure UK government and government backed institutions.
- Although the investment strategy allows investments up to 364 days, restrict deposits to a short a time period as feasible.

6.3 The City Council's temporary cash balances are managed by the City Treasurer in-house and invested with those institutions listed in the City's Approved Lending List. Officers can confirm these institutions meet the security criteria set out in the Annual Investment Strategy and the approved limits were not breached in the first half of 2009/10.

## 7 Temporary Borrowing and Investment Outturn for the first half of 2009-10

7.1 As illustrated in the economic background section (Appendix 1), investment rates available in the market are at an historical low point. The average level of funds available for investment purposes in the first half of 2009/10 was £14m. These funds were available on a temporary basis and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants, progress on the Capital Programme and dates at which external borrowing was taken.

7.2 Detailed below is the result of the temporary investment and borrowing undertaken by the Council. As illustrated, the authority outperformed the benchmark by 18bp on investments and 17bp on borrowing.

	Average temporary Investment /borrowing	Net Return/Cost	Benchmark Return / Cost *
Temporary Investments	£14.075m	0.63%	0.45%
Temporary Borrowing	£20.404m	0.41%	0.58%

\* Average 7-day LIBID / LIBOR rate sourced from Sector

7.3 None of the institutions in which investments were made show any difficulty in repaying investments and interest in full during the year. The list of institutions in which the Council invests is kept under continuous review.

## 8 Conclusion

8.1 The current borrowing position reflects the strong balance sheet of the council. It enables net interest costs to be minimised and reduces credit risk by making temporary use of internal borrowing (reserves, provisions, positive cash flows etc). Although some new borrowing has been taken the policy remains to keep cash as low as possible and not to borrow in advance of need for capital purposes.

8.2 Proactive treasury management during the year has enabled us to achieve an average net return on our investments of 0.63%, which is significantly better than the Benchmark Average 7-day LIBID rate of 0.45% and an average net cost of temporary borrowing of 0.41% which is better than the benchmark of 0.58%. In addition, the average rate of interest on the Council's overall debt reduced from 5.34% to 4.76%, in the main due to high interest PWLB debt being redeemed by the government and

new PWLB debt being taken on close to the lowest interest rates available so far this year.

- 8.3 Consideration will be given to further borrowing during this financial year depending on the interest rates available and the need to borrow to meet the councils cash needs. Whilst the council has in the past made substantial use of market funds there is less availability in the market since the 'credit crunch' and PWLB loans are seen as providing more certainty and better value. However all alternatives available will be considered.

## Review of Economic Conditions April to September 2009

- 1 The first half of 2009/10 saw:
  - There are some signs of recovery in the market, with some sectors showing growth
  - Concerns remain about the fragile state of any recovery with the impact of rising unemployment, therefore bank rate/investment rates expected to stay lower for longer
  - House prices rise at the fastest rate in over five years;
  - An extension of the Bank of England's quantitative easing programme but limited success in boosting credit or money supply growth;
  - Unemployment continue to rise and pay growth weaken further;
  - Inflationary pressures in the economy ease further, but more slowly than had been expected;
  - Conditions in financial markets improve further, and equity prices rally strongly;
  - The pound fall back, yielding much of the gains made in the first quarter;
  - Other major economies exit the recession, including the US.
- 2 April's Budget announced an injection of £5.2bn in 2009/10, but a tightening of £5.2bn in 2011/12. The Chancellor forecast that public sector net borrowing would increase to 12.5% of GDP in 2009/10 and that net debt as a percentage of GDP will leap from 41.2% in 2008/09 to 62.9% in 2009/10, before peaking at 94.2% in 2015/16. This may have a significant impact on the UK economy.
- 3 After rapidly cutting official interest rates to a record low of 0.5%, the MPC increased the amount of asset purchases under the Bank's quantitative easing (QE) programme from £75bn to £125bn in May. The MPC still retains the option to extend these purchases by a further £25bn before having to ask the Chancellor for further authorisation. However, while QE does at least seem to have been successful in improving liquidity in financial markets, its impact on the real economy remains limited.
- 4 At its meeting in August, the Monetary Policy Committee (MPC) increased the amount of asset purchases under the Bank's quantitative easing (QE) programme by £50bn to £175bn.
- 5 Net lending to businesses increased in August for the first month since March, however, the household sector as a whole reduced unsecured debt in August. Banks are likely to remain reluctant to lend while conditions in the labour market are still deteriorating. The claimant count rose by 25,200 in July and 24,400 in August. While these were smaller rises than in the first quarter, they were enough to take the claimant count above 1.6m, the highest level since Q2 1997.
- 6 Inflationary pressures within the economy continued to reduce in the first quarter of 09/10, although at a slower rate than had been expected. The key factors in this trend are tax rises and increasing oil prices. In the second quarter they eased further, although at a slower rate than in the first quarter. CPI inflation fell from 1.8% in June to 1.6% in August, largely as a result of falls in the annual rate of food and utility price

inflation. However, core inflation rose from 1.6% in June to 1.8% in August – a higher rate than in other advanced economies. The rise most likely reflects the lagged impact of the pound's depreciation last year, and so should prove temporary.

7 The most upbeat news was from the housing market. The Nationwide house price index rose 3.8% in Q2, the largest quarterly rise since Q2 2004. House prices by this measure are now only 13.5% below their peak. And while the Halifax measure remained more downbeat, it too posted increases in the quarter. However, the rise in house prices appeared to be largely driven by the scarcity of homeowners putting their homes up for sale, suggesting that the rises may therefore only be temporary.

## 8 Economic Forecast

The Council's Treasury Advisers, Sector, provides the following forecast:

	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Bank rate	0.50%	0.50%	0.50%	0.75%	1.25%	1.75%	2.50%	3.00%	3.75%	4.00%	4.25%	4.50%	4.50%	4.50%
5yr PWLB rate	2.80%	2.90%	3.10%	3.20%	3.30%	3.55%	3.85%	4.15%	4.55%	4.60%	4.80%	4.80%	4.85%	4.85%
10yr PWLB rate	3.75%	3.80%	3.90%	4.00%	4.15%	4.30%	4.55%	4.75%	4.95%	5.00%	5.10%	5.15%	5.15%	5.15%
25yr PWLB rate	4.35%	4.45%	4.55%	4.60%	4.70%	4.90%	5.00%	5.00%	5.10%	5.20%	5.30%	5.30%	5.35%	5.35%
50yr PWLB rate	4.50%	4.55%	4.70%	4.75%	4.90%	5.00%	5.15%	5.15%	5.20%	5.25%	5.40%	5.40%	5.45%	5.45%

- The forecast is based on moderate economic recovery and moderate MPC concerns about inflation looking 2 years ahead
- The first Bank Rate increase is expected to be in Q2 of 2010/11
- Bank Rate to reach 4.5% in Q2 of 2012/13
- Long term PWLB rates to steadily increase to reach 5.45% by the end of 2012 due to high gilt issuance, reversal of QE and investor concerns over inflation
- There is a high level of uncertainties in all the above forecasts. This is due to the difficulties of forecasting the timing and amounts of QE reversal, fiscal contraction after the general election expected by May 2010, speed of recovery of banks' profitability and balance sheet positions, changes in the consumer saving ratio and rebalancing of the UK economy towards exports.

**TREASURY MANAGEMENT PRUDENTIAL INDICATORS : 2009-10**

**Performance to 30 September 2009**

	<b>Original</b>	<b>Minimum In Year to 30/09/09</b>	<b>Maximum In Year to 30/09/09</b>
	<b>£000</b>	<b>£000</b>	<b>£000</b>
<b>Operational Boundary for External Debt -</b>			
Borrowing	£1,028,000	£565,099	£655,585
Other Long Term Liabilities	£0	£0	£0
<b>Authorised Limit for External Debt -</b>			
Borrowing	£1,167,000	£565,099	£655,585
Other Long Term Liabilities	£0	£0	£0
	<b>Actual as at 30 Sept 2009</b>		
<b>Authority has adopted CIPFA's Code of Practice for Treasury Management in the Public Services</b>	Yes	Yes	
<b>Upper Limit for Fixed Interest Rate Exposure</b>			
Net Borrowing at Fixed Rate as a percentage of Total Net Borrowing	73%	64%	
<b>Upper Limit for Variable Interest Rate exposure</b>			
Net Borrowing at Variable Rate as a percentage of Total Net Borrowing	71%	36%	
<b>Upper Limit for Principal Sums Invested for over 364 days</b>	£0	£0	

	<u>Lower Limit</u>	<u>Upper Limit</u>	<b>Actual as at 30 Sept 2009</b>
	<b>2009-10 Original</b>	<b>2009-10 Original</b>	
<b>Maturity structure of Fixed Rate Borrowing</b>			
under 12 months	0%	50%	0%
12 months and within 24 months	0%	60%	28%
24 months and within 5 years	20%	70%	47%
5 years and within 10 years	0%	60%	11%
10 years and above	0%	60%	15%

## Glossary of Terms

**Authorised Limit** - This represents the limit beyond which borrowing is prohibited, and needs to be set and revised by the Council. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need, with some headroom for unexpected movements.

**Bank Rate** – the rate at which the Bank of England offers loans to the wholesale banks, thereby controlling general interest rates in the economy.

**Counterparty** – the other party involved in a borrowing or investment transaction.

**Credit Rating** – A qualified assessment and formal evaluation of an institution's (bank or building society) credit history and capability of repaying obligations. It measures the probability of the borrower defaulting on its financial obligations, and its ability to repay these fully and on time.

**Discount** – Where the prevailing interest rate is higher than the fixed rate of a long-term loan, which is being repaid early, the lender can refund the borrower a discount. This is calculated on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender is able to offer the discount, as their investment will now earn more than when the original loan was taken out.

**Fixed Rate Funding** - A fixed rate of interest throughout the time of the loan. The rate is fixed at the start of the loan and therefore does not affect the volatility of the portfolio, until the debt matures and requires replacing at the interest rates relevant at that time.

**Liquidity** – The ability of an asset to be converted into cash quickly and without any price discount. The more liquid a business is, the better able it is to meet short-term financial obligations.

**LIBOR** – (London Interbank Offer Rate). The interest rate at which banks offer to take short-term borrowing from other banks in the London interbank market.

**LOBO** – Lender Option Borrower Option. Long-term borrowing deals structured in a such a way that a low rate of interest is usually offered for a short, initial period (anything from 1 year to 7 years), followed by a “step up” to a higher rate of interest (the “back end” interest rate), which is to be charged for the remainder of the loan period. The overall length of LOBOs is usually 50 or 60 years, but can be for shorter or longer periods. After the “step up” date, and at set intervals thereafter, the lender (the bank) has the option of increasing the “back end” interest rate. Whenever this option is exercised, if the proposed new interest rate is unacceptable, the borrower (the City Council) can redeem the loan without penalty. The City Treasurer has, more recently, looked at Vanilla LOBO loans, which have an interest rate which remains constant throughout the life of the loan, although still potentially subject to change at the lender's option.

**Market** - The private sector institutions - Banks, Building Societies etc.

**Maturity Profile/Structure** - an illustration of when debts are due to mature, and either have to be renewed or money found to pay off the debt. A high concentration in one year will make the Council vulnerable to current interest rates in that year.

**Operational Boundary** – This indicator is based on the probable external debt during the course of the year; it is not a limit and actual borrowing could vary around this boundary for short times during the year. It should act as an early warning indicator to ensure the Authorised Limit is not breached.

**Premium** – Where the prevailing current interest rate is lower than the fixed rate of a long-term loan, which is being repaid early, the lender can charge the borrower a premium. This is calculated on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender may charge the premium, as their investment will now earn less than when the original loan was taken out.

**Prudential Code** - The Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

**PWLB** - Public Works Loan Board. An institution managed by the Government to provide loans to public bodies at rates which reflect the rates at which the government is able to sell Gilts.

**Volatility** - The degree to which the debt portfolio is affected by current interest rate movements. The more debt that matures in the year and needs replacing, and the more debt subject to variable interest rates, the greater the volatility.

**Yield Curve** - A graph of the relationship of interest rates to the length of the loan. A normal yield curve will show interest rates relatively low for short term loans compared to long term loans. An inverted Yield Curve is the opposite of this.

