Manchester City Council
Report for Resolution

Report To:	Executive
Date:	24th June 2009
Subject:	Treasury Management Annual Report 2008-09
Report Of:	City Treasurer

Purpose Of Report:

To report the Treasury Management activities of the Council during 2008-09.

Recommendations:
The Executive is asked to note the report.

Financial Consequences For The Revenue Budget
None directly.

Financial Consequences For The Capital Budget
None.

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Background Documents
Treasury Management Strategy Statement and Borrowing Limits and Annual Investment Strategy Report 2008/09 (Executive Committee 13 February 2008)
Accounting and Financial records held in room 102.

Wards Affected
Not Applicable

Implications For:

Anti Poverty	**Equal Opportunities Employment**	**Environment**	
None	None	None	None

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 A requirement of the Council's Treasury Policy Statement is the reporting to the Executive of both the expected treasury activity for the forthcoming financial year (the Treasury Management Strategy Statement and Borrowing Limits and Annual Investment Strategy Report 2008/09 (Executive Committee 13 February 2008)) and subsequently the results of the Council's treasury management activities in that year (this report). 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 annual report covers:

- the Council's treasury position as at 31st March 2009
- the outturn for 2008-09
- compliance with treasury limits and Prudential Indicators
- investment strategy and outturn for 2008-09
- debt rescheduling

A glossary of terminology used in this report is attached in Appendix 3.

2 Current Portfolio Position

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

Loan Type	31 March 2008 Principal £m	31 March 2008 Average Rate %	31 March 2009 Principal £m	31 March 2009 Average Rate %
PWLB	202.0	8.89	* 100.3	8.87
Temporary	15.5	5.48	1.7	0.43
Market Loans	559.6	4.85	549.6	4.89
Stock	8.3	3.36	8.2	3.36
Special (ITA)	0.4	5.13	22.9	0.50
Gross Total	**785.8**	**5.89**	**682.7**	**5.30**
Temporary Deposits	(25.1)	5.67	(6.2)	0.45
Net Total	**760.7**	**5.89**	**676.5**	**5.34**

* The PWLB figures as at 31 March 2009 included above do not reflect the impact of the East Manchester LSVT (see below), which took place on 30 March 2009. The repayment of PWLB debt by the Department for Communities and Local Government (DCLG) went ahead on 2 April 2009, reducing the debt by £94.1m. As the agreement with the DCLG results in a percentage reduction in the value of each PWLB loan, equivalent to the percentage of properties being transferred to Housing Association control, there is no effect on the average PWLB interest rate shown above. Gross Total and Net Total Average Interest Rates, however, reduce to 4.73% and 4.77% respectively.

Fair Value

The SORP 2008 requires the council to disclose the fair value of each class of financial asset and liability to enable a comparison with the carrying amounts. The fair values have been determined by reference to the PWLB redemption rules and prevailing PWLB redemption rates as at each balance sheet date and include accrued interest. They, therefore, differ from the principal amounts outstanding detailed in paragraph 2.1 above. The fair value for non - PWLB debt has also been calculated using the same procedures and interest rates, providing a sound approximation of the fair value of these instruments. The SORP states that fair value disclosures are not required for short – term payables and receivables, since the carrying amount is a reasonable approximation of fair value.

Fair Value at Amortised Cost

	Carrying Amount 31-Mar-08 £000s	Carrying Amount 31-Mar-09 £000s	Fair Value 31-Mar-08 £000s	Fair Value 31-Mar-09 £000s
PWLB Debt	202,694	100,337	263,571	135,142
Non PWLB debt	575,687	549,640	635,898	615,142
Stocks	8,306	8,233	6,428	7,019
Total debt	786,687	658,210	905,897	757,303

3 Review of Economic Conditions 2008-09

3.1 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 (Consumer Prices Index), 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 the spread between Bank Rate and 3 month LIBOR was greater than had historically been the case.

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 de-stabilise them. 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 and Lloyds, as liquidity in the markets dried up. The Monetary Policy Committee, meantime, had reduced interest rates by 0.50% 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.

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 at the longer end because of the economic consequences of 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.

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.

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 that 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.

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 have allowed indebted local authorities to benefit.

3.2 The movement in short and long-term interest rates for the year is shown in Appendix 1. Average PWLB interest rates for 2008/09 were as follows

1 month variable	3.682%
1 year	3.264%
9.5 – 10 year	4.477%
25 – 30 year	4.570%
49.5 – 50 year	4.438%

4 Treasury Borrowing in 2008-09

4.1 No new long-term borrowing was undertaken during 2008-09. This was in line with the long-term borrowing strategy for the year, the amount of borrowing required during the year (£76.6m) being funded from cash backed reserves and short-term temporary borrowings, to defer long-term borrowing.

4.2 The table in paragraph 2.1 above shows that the average rate of interest paid has decreased over the course of the year, from 5.89% to 5.34%. This was mainly as a result of reductions in the interest rates payable on Temporary and Special loans, which largely track Bank Rate, which showed significant reductions at regular intervals during the year.

5 Compliance with Treasury Limits

5.1 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 Appendix 2.

6 Investment Strategy for 2008-09

6.1 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. The Authority invests for a range of periods, from overnight to 364 days, dependent on its cash flow estimates and the interest rates on offer.

7 Investment Outturn for 2008-09

7.1 Detailed below is the result of the investment strategy undertaken by the Council.

	Average Investment	Net Return	Benchmark Return *
Temporary Investments	£24.759m	4.77%	3.69%

* *Average 7-day LIBID rate (uncompounded) sourced from the Financial Times.*

7.2 We had no investments with Icelandic banks at the time they went into receivership, nor did any other 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.

7.3 A chart showing the Council's average monthly Cash Flow surplus / deficit position throughout the year is attached as Appendix 4.

8 Debt Rescheduling

8.1 The PWLB will allow local authorities to repay existing loans early and, depending on whether current interest rates are higher or lower than the loans to be repaid, a lump sum discount is received or a premium paid. Circumstances are constantly reviewed to see whether it would be beneficial to restructure any of the City's loans. Rescheduling opportunities presented themselves until 1st November 2007, when the PWLB radically changed the structure of its rates.

8.2 On 1st November 2007, the PWLB imposed two rates for each period, one for new borrowing and a new, significantly lower rate for early repayment of debt. The differential between the two rates ranged from 26 basis points in the shorter dated maturities to over 40 basis points in the longer ones. They also introduced daily movements of 1 basis point instead of 5 basis points and rates in half year periods throughout the maturity range (previously they had been mainly in 5 year bands).

8.3 As things stand, these changes effectively prevent the Council from restructuring any of the loans in its PWLB debt portfolio, but nearly all loans remaining have interest rates such as to make restructuring costly and unattractive. For these reasons, no PWLB rescheduling was undertaken during the year.

9 Housing Large Scale Voluntary Transfers (LSVTs)

9.1 From 2004/05, the agreement with the Department for Communities and Local Government (DCLG) on Large Scale Voluntary Transfers (LSVTs) of Housing stock is that it will redeem equivalent PWLB debt associated with those properties being transferred to Housing Association control.

9.2 Transfers of Housing stock on the Stockport Overspill, City South and East estates took place in April and June 2008 and March 2009 respectively.

9.3 Advice from Sector, our Treasury advisers, with regard to this transfer, was that a pro rata reduction of each PWLB loan would be the most suitable approach. This was adopted and resulted in the Council's PWLB debt being reduced by £193.164m.

9.4 A further transfer is expected to take place on West Gorton estate in April 2010, which will complete the transfer process. As the programme of transfers is finalised, work with Sector will continue to establish strategies that ensure the Council's long-term interests are protected.

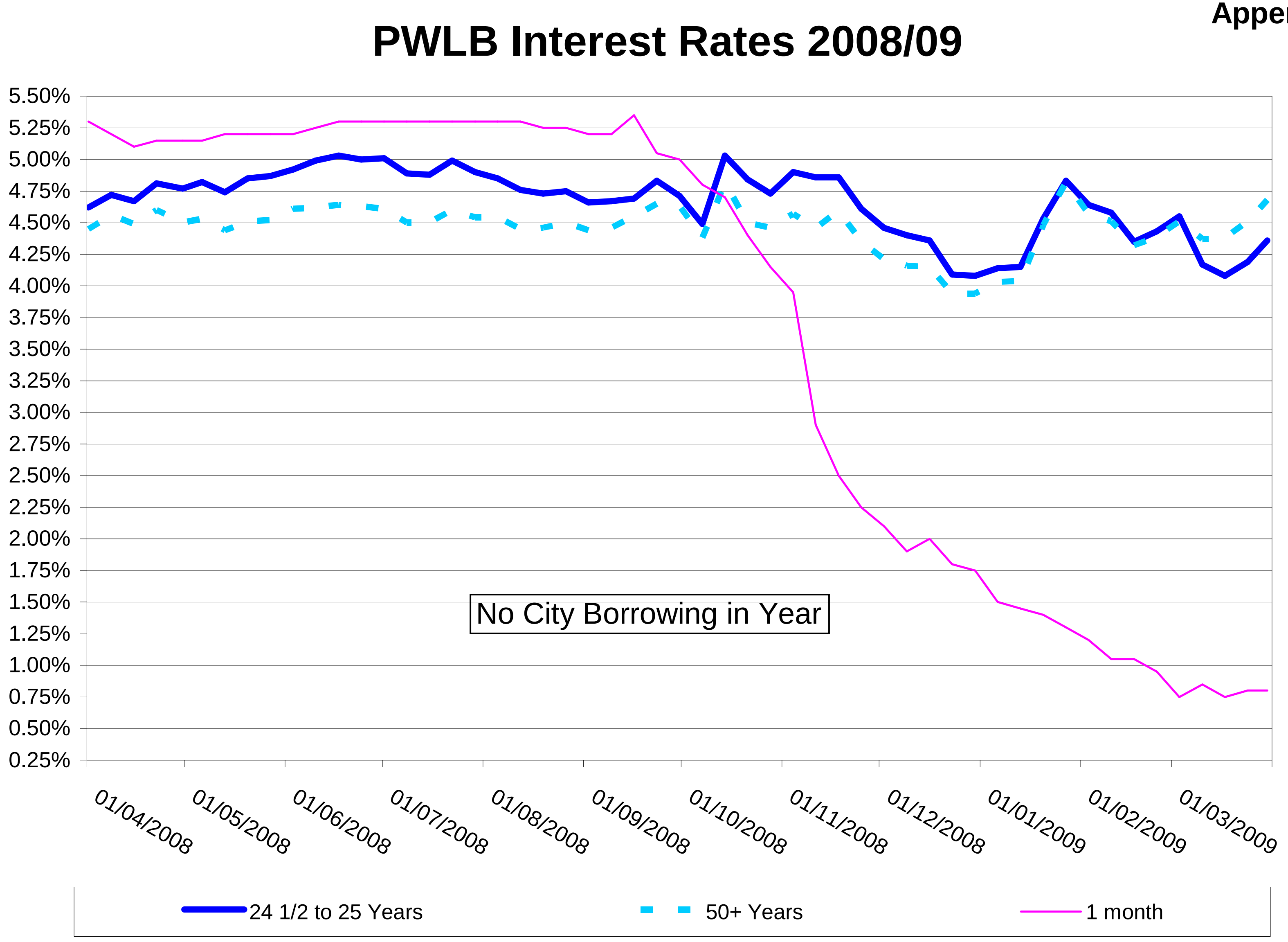
9.5 The financial impact on the Council's debt of the final LSVT will be reported in a future year's Annual Report.

10 Conclusion

10.1 Proactive treasury management during the year has enabled us to achieve an average net return on our investments of 4.77%, which is significantly better than the Benchmark Average 7-day LIBID rate of 3.69%. In addition, the average rate of interest on the Council's overall debt reduced from 5.89% to 5.34%, in the main due to significant reductions in Bank Rate during the year impacting on the level of interest rate payable on Temporary and Special loans.

10.2 Following the well publicised problems of some local authorities with regard to the security of their short/medium term treasury investments, a further report on the City Council's Treasury Management activities has recently been submitted to the Resources and Governance Overview and Scrutiny Committee.

Appendix 1


PWLB Interest Rates 2008/09
5.50%
5.25%
5.00%
4.75%
4.50%
4.25%
4.00%
3.75%
3.50%
3.25%
3.00%
2.75%
2.50%
2.25%
2.00%
1.75%
1.50%
1.25%
1.00%
0.75%
0.50%
0.25%
No City Borrowing in Year
01/04/2008
01/05/2008
01/06/2008
01/07/2008
01/08/2008
01/09/2008
01/10/2008
01/11/2008
01/12/2008
01/01/2009
01/02/2009
01/03/2009
24 1/2 to 25 Years
50+ Years
1 month

Appendix 2

TREASURY MANAGEMENT PRUDENTIAL INDICATORS : 2008-09

	Original £000	Minimum In Year £000	Maximum In Year £000
Operational Boundary for External Debt -			
Borrowing	£1,104,398	£659,139	£785,747
Other Long Term Liabilities	£0	£0	£0
Authorised Limit for External Debt -			
Borrowing	£1,304,492	£659,139	£785,747
Other Long Term Liabilities	£0	£0	£0
		Actual as at 31 March 2009	
Authority has adopted CIPFA's Code of Practice for Treasury Management in the Public Services	Yes	Yes	
Upper Limit for Fixed Interest Rate Exposure			
Net Borrowing at Fixed Rate as a percentage of Total Net Borrowing	83%	58%	
Upper Limit for Variable Interest Rate exposure			
Net Borrowing at Variable Rate as a percentage of Total Net Borrowing	63%	42%	
Upper Limit for Principal Sums Invested for over 364 days	£0	£0	

	<u>**Lower Limit**</u>	<u>**Upper Limit**</u>	
Maturity structure of Fixed Rate Borrowing	**2008-09 Original**	**2008-09 Original**	**Actual as at 31 March 2009**
under 12 months	0%	50%	0%
12 months and within 24 months	10%	60%	20%
24 months and within 5 years	10%	60%	38%
5 years and within 10 years	0%	60%	17%
10 years and above	10%	60%	25%

Appendix 3

Glossary of Terms

ALMO (Arms Length Management Organisation) - a company set up by a local authority to manage and improve all or part of its housing stock. The company is owned by the local authority and operates under the terms of a management agreement between the authority and the ALMO. High performing ALMOs are eligible for additional funding from the Government.

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.

Carrying Amount – the amount of principal and accumulated interest outstanding on loans or investments with a third party (e.g., banks, building societies).

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.

Fair Value - this is defined as the amount that the asset or liability could be exchanged for, assuming that the transaction was negotiated between parties knowledgeable about the market in which they are dealing and willing to buy or sell at an appropriate price.

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.

GBR – Government Borrowing Rate. This is the rate the Public Works Loan Board charges for borrowing variable loans.

Gilts - The loan instruments by which the Government borrows. Interest rates will reflect the level of demand shown by investors when the Government auctions Gilts.

High/Low Coupon – High/Low interest rate

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.

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.

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.

Minimum Revenue Provision – the Council must set aside a Minimum Revenue Provision (MRP) of 4% of its External General Fund debt, plus 4 % of any new General Fund borrowings, as a debt redemption provision.

Monetary Policy Committee (MPC) – the independent body which determines Bank Rate.

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.

PFI (Private Finance Initiative) – with regard to Housing, PFI is the award of a long-term contract from a local authority to a PFI private sector operator, who will provide additional investment in social housing to meet central government’s Decent Homes Standard. The PFI operator will refurbish all the properties within the scheme up to the Decent Homes Standard and maintain them at or above that standard for the rest of the contract, typically 30 years. The operator will also provide housing related services, such as rent collection, to the tenants. In return, the operator will receive an annual performance based charge throughout the contract. With public sector housing, the local authority continues to own the properties and the tenants remain tenants of the local authority.

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.

SORP - Code of Practice on Local Authority Accounting in the United Kingdom - A Statement of Recommended Practice. This is based on approved accounting standards.

Specified Investments - Sterling investments of not more then one-year maturity. These are considered low risk assets, where the possibility of loss of principal or investment income is very low.

Non-specified investments - Investments not in the above, specified category, e.g., foreign currency, exceeding one year or outside our minimum credit rating criteria.

Toxic Debt - Like the expression credit crunch, toxic debt is a new phrase born of the economic downturn. It is used to describe a class of assets that once had value - or were perceived to hold value by banks - but are now worthless, or at least have a reduced value which is hard to establish. The most often quoted examples of toxic debt are the US sub prime mortgages, which were home loans to people who could not really afford to pay them back. The banks hoped these loans would be secured against the value of the homes, even if people defaulted on their payments. But once large numbers of people started to default, and a glut of property came onto the market, suddenly the value of houses plummeted. Thus, the assets became toxic.

Variable Rate Funding - The rate of interest either continually moves to reflect interest rates of the day, or can be tied to specific dates during the loan period. Rates may change on a monthly, quarterly or annual basis.

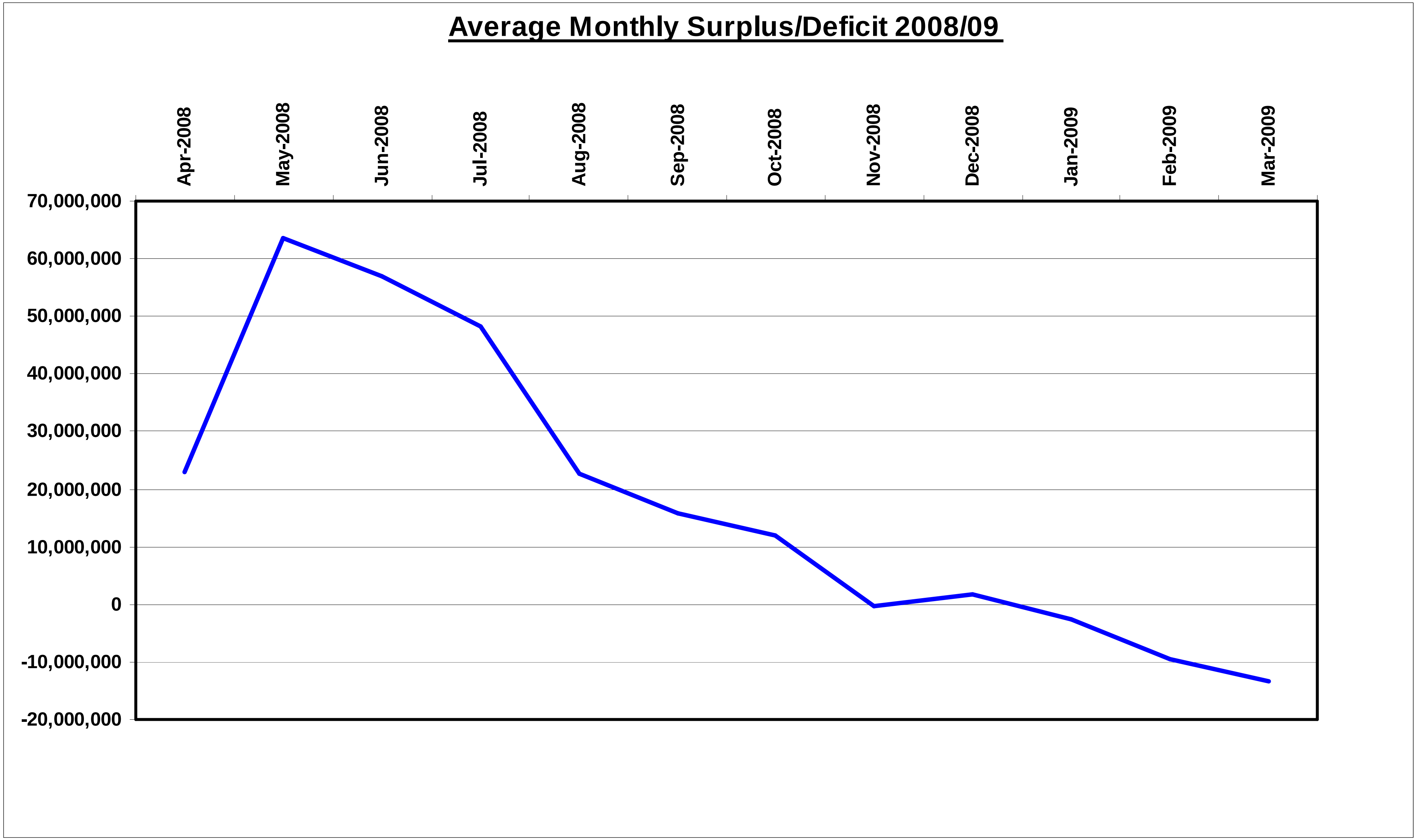
Volatility - The degree to which the debt portfolio is affected by current interest rate movements. The more debt that matures in the year and needs replacing, and the more debt subject to variable interest rates, the greater the volatility.

Weighted Average Interest Rate – There are several ways of weighting an interest rate calculation (e.g. period in years, months or days), but, for the Council's Treasury

Management activities, the weighted average interest rate for a number of borrowing or investment loans is derived by taking into account the amount of the principal over a particular period, not just its interest rate.

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.

Appendix 4


Average Monthly Surplus/Deficit 2008/09
Apr-2008
May-2008
Jun-2008
Jul-2008
Aug-2008
Sep-2008
Oct-2008
Nov-2008
Dec-2008
Jan-2009
Feb-2009
Mar-2009
70,000,000
60,000,000
50,000,000
40,000,000
30,000,000
20,000,000
10,000,000
0
-10,000,000
-20,000,000