DEVON & SOMERSET FIRE & RESCUE AUTHORITY

REPORT REFERENCE NO.	**RC/09/7**
MEETING	**RESOURCES COMMITTEE**
DATE OF MEETING	**14 SEPTEMBER 2009**
SUBJECT OF REPORT	**TREASURY MANAGEMENT PERFORMANCE 2008/2009 AND 2009/2010 (TO JULY 2009)**
LEAD OFFICER	**TREASURER**
RECOMMENDATIONS	***That the performance in relation to the treasury management activities of the Authority, for both 2008/2009 and 2009/2010 (to date), be noted.***
EXECUTIVE SUMMARY	The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management, requires that the Authority receives a report of the treasury management activities for the previous financial year. This report provides information relating to the performance of the Authority for 2008/2009, in respect of borrowing and investment activities during the year, and compares this performance against the treasury management strategy adopted. The report also includes a performance report relating to the current financial year, as at July 2009.
RESOURCE IMPLICATIONS	As indicated within the report.
EQUALITY IMPACT ASSESSMENT	An initial assessment has revealed that there are no equality issues arising from this report.
APPENDICES	A. Investments held as at 31 March 2009. B. Investments held as at 31 July 2009
LIST OF BACKGROUND PAPERS	Treasury Management Policy – as approved at the meeting of the Shadow DSFRA meeting held on the 16 March 2007. Revision to the Treasury Management Policy, as approved at the DSFRA meeting held on the 31 March 2009.

1. INTRODUCTION

1.1 The Treasury Management Strategy for Devon and Somerset Fire and Rescue Authority (DSFRA) had been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2001. The Code was originally adopted by the Shadow Authority at its meeting on 16 March 2007 (Minute SDSFRA/52 refers), with the most recent revision being approved by the Authority at its meeting on 31 March 2009 (Minute DSFRA/89 refers). The Authority fully complies with the primary requirements of the Code, which includes:

- The creation and maintenance of a Treasury Management Policy Statement, which sets out the policies and objectives of the Authority's treasury management activities.
- The creation and maintenance of Treasury Management Practices, which set out the manner in which the Authority will seek to achieve those policies and objectives.
- The receipt by the Authority of an annual strategy report for the year ahead and an annual review report of the previous year.
- The delegation by the Authority of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

1.2 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. "*

1.3 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 a year, but preferably quarterly. This report therefore ensures this Authority 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. The report is split into two parts, Section 1 reports on the performance of the authority's treasury management activities in relation to 2008/2009, and Section 2 reports on the performance so far in the current financial year, based upon the position at the end of July 2009.

SECTION 1

2. TREASURY MANAGEMENT PERFORMANCE FOR 2008/2009

2.1 This Annual Treasury Report includes:

- the Authority's treasury position as at 31 March 2009;
- the strategy for 2008/09;
- the economy in 2008/09;
- borrowing and investment rates in 2008/09;
- the borrowing outturn for 2008/09;
- compliance with treasury limits and Prudential Indicators;
- investment outturn for 2008/09;
- debt rescheduling;

3. THE CURRENT TREASURY POSITION

3.1 The Authority's debt and investment position at the beginning and the end of the year is shown in Table 1 below:

TABLE 1 – SUMMARY OF DEBT AND INVESTMENT POSITION FOR 2008/2009

	31st March 2009 Principal		Rate/ Return	Average Life yrs	31st March 2008 Principal	Rate/ Return	Average Life yrs
BORROWING							
Fixed Rate Funding:							
- Public Works Loan Board (PWLB)	£19.281m				£16.223m		
- Market	£0.000m	£19.281m	4.212%	18.2	£0.000m	4.423%	35.5
Variable Rate Funding:							
- PWLB	£0.000m				£0.000m		
- Market	£0.000m	£0.000m	0.000%		£0.000m	0.000%	
Total Debt		***£19.281m***	***4.212%***	***18.2***	***£16.223m***	***4.423%***	***35.5***
INVESTMENTS							
Investments:							
- In-House	£3.010m		3.836%		£5.200m	5.683%	
Total Investments		***£3.010m***	***3.836%***		***£5.200m***	***5.683%***	

3.2 The above figures illustrate that the average borrowing rate has reduced from 4.423% to 4.212%, whilst the average investment rate has reduced, from 5.683% to 3.836%.

4. THE STRATEGY FOR 2008/2009

4.1 The Sector-recommended treasury strategy for 2008/09 (issued in January 2008) was based on their view of a declining rate of growth of Gross Domestic Product (GDP) in the UK economy from the peak of 3.3% in Q3 2007 to 2% in 2008. Bank Rate was expected to continue falling from 5.75% in November 2007 to reach 5.0% in Q2 2008 and then stay there for the rest of the financial year. This was based around the dilemma facing the Monetary Policy Committee (MPC) of balancing the opposing risks of inflationary pressures driven by spikes in oil prices against concerns around the impact of the credit crunch both on the UK housing market and economy and even more so on the US housing market and economy and the knock on impact on world growth rates.

4.2 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 Bank Rate would be stable in 2008-09 at 5.25% based on a balance of risks around rising inflationary pressures on the one hand and falling growth rates and concerns over the impact of the credit crunch on the other hand.

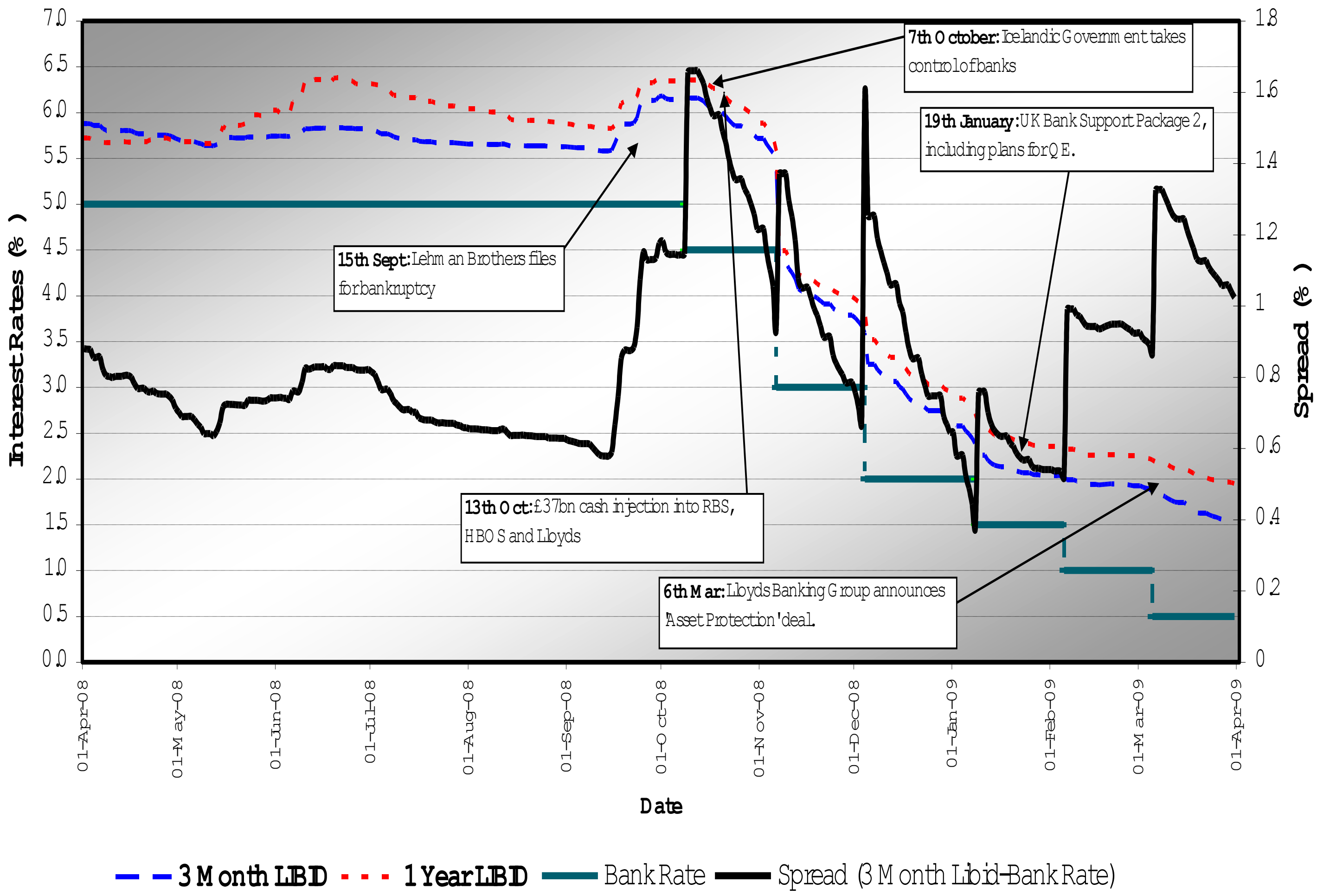
- **Longer-term interest rates** - The view on longer-term fixed interest rates, 50 years, was that they would remain static around 4.45% for the whole of the year. The 25 year rate would also remain flat around 4.50 - 4.55%.

4.3 The Treasury Strategy agreed by the Authority was on the basis that prudence should be adopted to treasury management decisions, and as such priority be given to liquidity and security rather than yield. In addition, as the Authority operated both borrowing and investment portfolios, it 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 a balanced treasury risk.

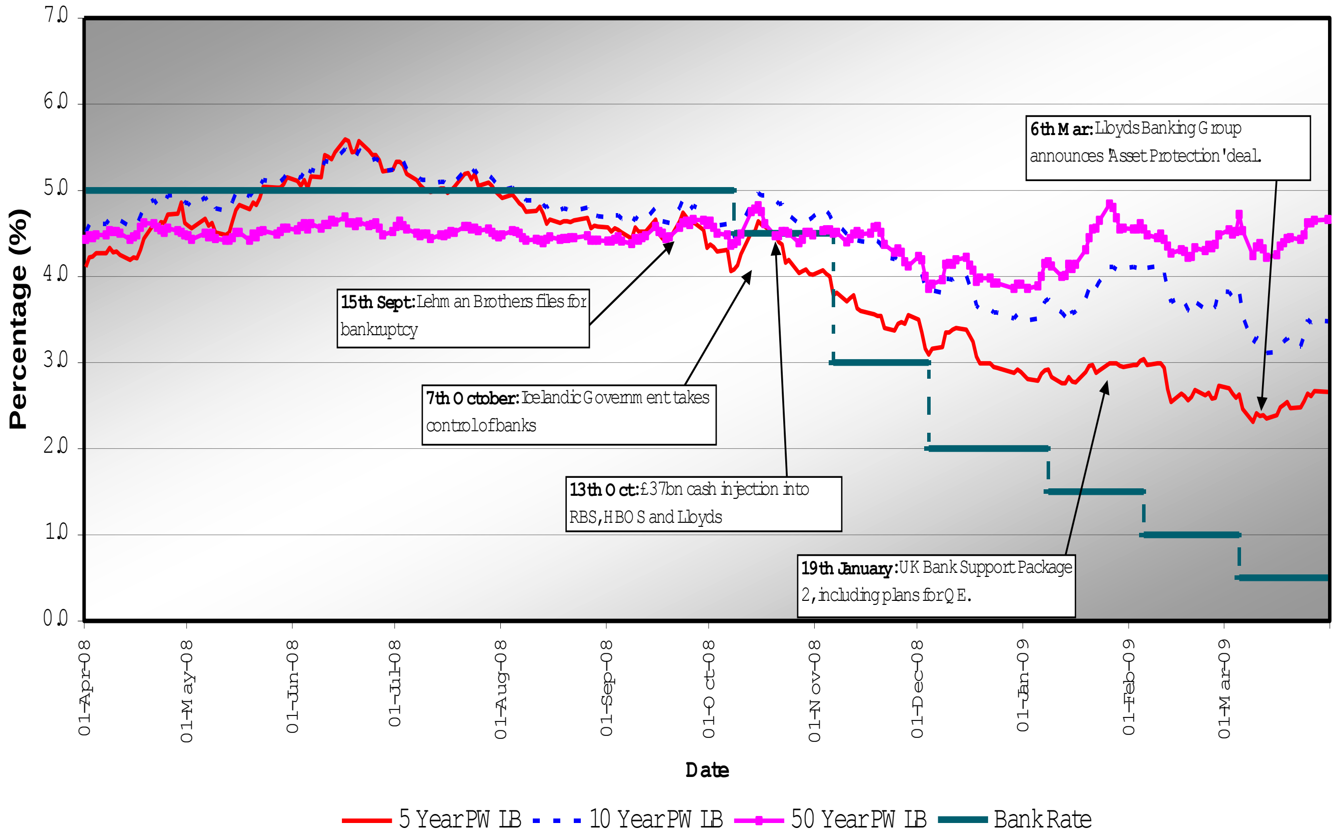
5. THE ECONOMY AND INTEREST RATES

5.1 In a year that can only be described as unparalleled and extraordinary the Annual Treasury Report for 2008/09 is summarised in the graphs below. These graphs show the major events of the financial year and the impact they had on both Public Works Loan Board (PWLB) and investment rates. The financial crisis, commonly known as the 'credit crunch', had a major downward impact on the levels of interest rates around the world. Although interest rates initially fell sharply in the US they were followed, eventually, by the Bank of England.

Bank Rate vs. Investment Rates 2008-09 and Spread Between 3 Month Libid & Bank Rate



PWLB Borrowing Rates vs. Bank Rate 2008-09



5.2 On the 1 April 2008 Bank Rate was 5.25% and the Bank of England was focused on fighting inflation. Market fears were that rates were going to be raised as the Consumer Price Index (CPI), 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, as shown in the graph, the spread between Bank Rate and 3 month London Inter-bank Offer Rate (LIBOR) was greater than had historically been the case.

5.3 This phase continued throughout the summer until 15 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 destabilise them. As can be seen from the charts 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 7 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/Lloyds, as liquidity in the markets dried up. The Monetary Policy Committee (MPC) meantime had reduced interest rates by 50bp on 9 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.

5.4 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 the longer end because of the economic consequences 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.

5.5 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 19 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.

5.6 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 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.

5.7 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 had allowed indebted local authorities to benefit.

6. BORROWING AND INTEREST RATES IN 2008/2009

6.1 12-month bid rates: One year London Inter-bank Bid Rate (LIBID) fluctuated between around 5.7% to 6.4% with two peaks driven by credit crunch fears in June and September. Bank Rate had been held at 5.0% until October 9 when the first of a series of major cuts caused 12 month LIBID in 2008-09 to be on a rapidly falling trend to the end of the financial year, reaching 1.85% at the end.

6.2 Longer-term interest rates – The PWLB 45-50 year rate started the year at 4.43% (25 year at 4.62%) and was then generally within a band of 4.3 - 4.6% (4.6% - 5.0%) until mid October when there was a spike up to 4.84% (5.08%) followed by a plunge down to 3.86% (4.03% late December) in early December. Further spikes of 4.84% (4.86%) and 4.72% (4.69%) occurred in late January and early February with the year closing out at 4.58% (4.28%). It was not uncommon to see rates fluctuating by 40-50 basis points within a few weeks during this year.

7. BORROWING OUTTURN 2008/2009

7.1 Further borrowing of £5.100m was taken out with the Public Works Loan Board (PWLB) during the financial year, as below.

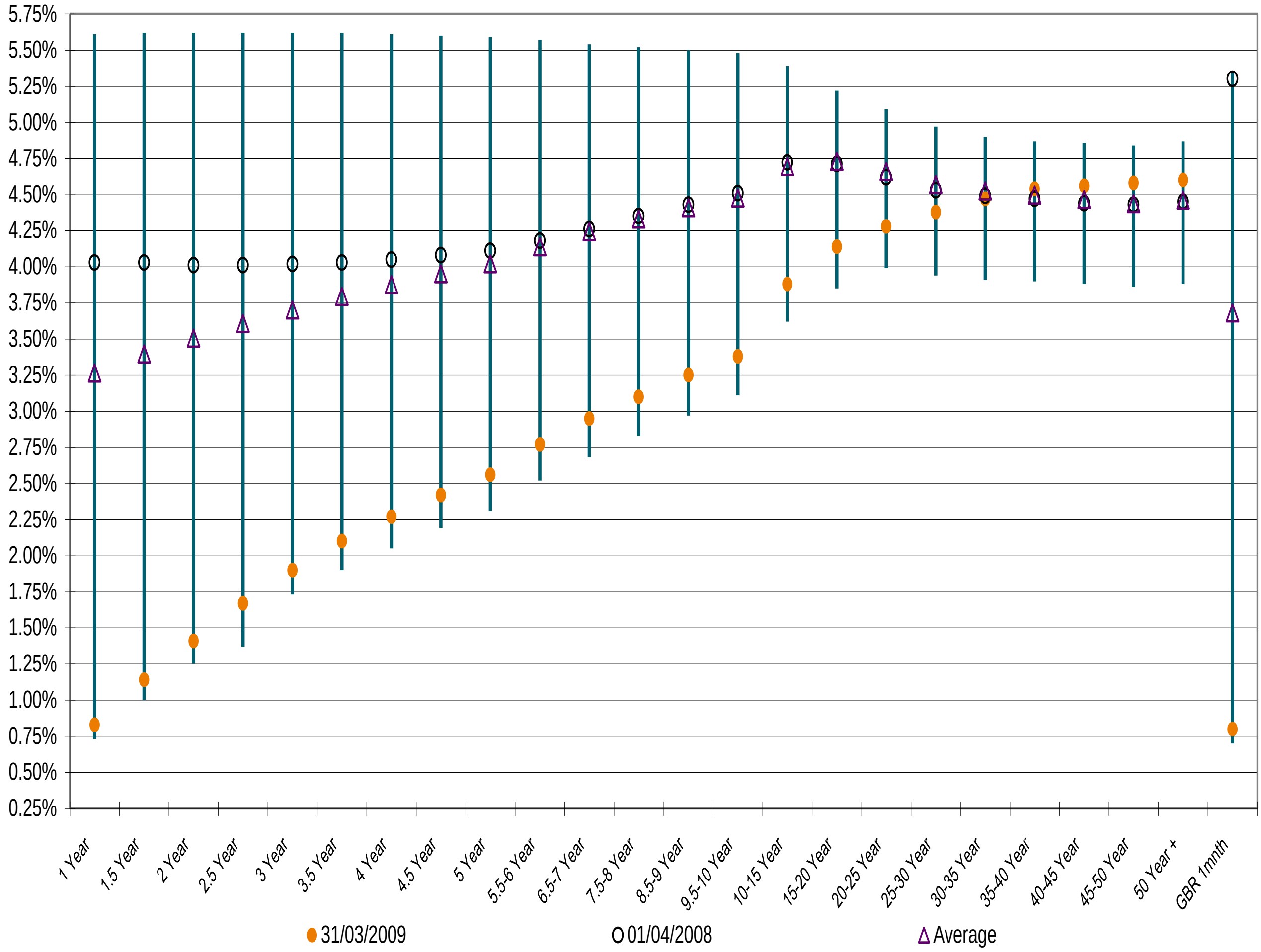
Date of Loan	Amount £m	Life (Years)	Interest Rate
29/08/2008	0.500	4.5	4.57%
17/09/2008	0.500	5.5	4.39%
17/09/2008	0.500	6.5	4.39%
17/09/2008	0.500	7.0	4.39%
17/09/2008	0.500	7.5	4.39%
07/10/2008	0.500	3.5	3.98%
29/10/2008	0.600	5.0	4.04%
05/12/2008	0.500	1.5	1.86%
05/12/2008	0.500	2.5	2.35%
05/12/2008	0.500	3.5	2.74%

7.2 As comparative performance indicators, average PWLB maturity loan interest rates for 2008/09 were:

1 year	3.264%
9.5 - 10 year	4.477%
24.5 - 25 year	4.570%
49.5 - 50 year	4.438%
1 month GBR variable	3.682%

7.3 The following graph shows the range (high and low points) in rates for each maturity period during the year, and individual rates at the start and end of the financial year:

PWLB Borrowing Rates



7.4 As highlighted in Table 1 above the average debt portfolio interest rate has moved over the course of the year from 4.423%% to 4.212%. The approach during the year was to take borrowing at short term rates to minimise any corresponding risk from maintaining short-term investments and to create a more balanced repayment profile.

8. <u>COMPLIANCE WITH TREASURY LIMITS</u>

8.1 During the financial year the Authority operated within the treasury limits and Prudential Indicators set out in the Authority's Treasury Policy Statement and annual Treasury Strategy Statement. The outturn figures for the Prudential Indicators were reported to the authority as included in the Financial Outturn 2008/2009 Report to the meeting of DSFRA held on the 27 May 2009 (report DSFRA/09/12 refers).

9. <u>INVESTMENT OUTTURN 2008/2009</u>

9.1 The Authority manages its investments in-house and invests with the institutions listed in the Authority approved lending list. The Authority invests for a range of periods from overnight to 364 days, dependent on the Authority's cash flows, its interest rate view and the interest rates on offer. Details of investments held as at 31 March 2009 are included at Appendix A.

9.2 The Authority viewed the market's expectation for Bank Rate 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.

9.3 Detailed below in Table 2 are the results of the investment strategy adopted by the authority.

TABLE 2 – INVESTMENT OUTTURN 2008/2009

	Average Investment £	Rate of Return %	*Benchmark Return ** %
Internally Managed Funds	13,032,106	3.84%	3.69%

** Benchmark return used is equivalent to the average 7 day LIBID rate during 2008/2009*

10. DEBT RESCHEDULING

10.1 Due to elevated concerns around the credit crunch at times during the year and near panic in financial markets at key points, there were wild swings in PWLB rates of around 100 basis points in PWLB long term rates within a matter of a few weeks. Advantage was taken of one of the peaks in long term rates in March 2009 to repay £1.665m of 25 to 30 year PWLB debt @ 4.7% to 4.88% and to borrow during 2009/10 3.83% to 4.37% in 12 to 16 year PWLB debt. This switch between longer term debt and short term debt was facilitated by falling short term PWLB rates after the MPC started its series of major cuts in Bank Rate in October 2008. This has enabled the Authority to rebalance its debt portfolio away from being heavy weight in longer term debt to having a better spread of maturity periods.

10.2 Details of debts rescheduled are as follows:-

Date Loan repaid	Amount £m	Life (Years)	Interest	Date of replacement Loan	Amount £m	Life (Years)	Interest
27/03/2009	1.000	30	4.70%	12/05/2009	0.400	15	4.32%
				12/05/2009	0.400	14	4.25%
				12/05/2009	0.200	16	4.37%
31/03/2009	0.500	25	4.75%	09/04/2009	0.500	12	3.83%
31/03/2009	0.165	25	4.88%	12/05/2009	0.165	16	4.37%

SECTION 2

11. TREASURY MANAGEMENT PERFORMANCE FOR 2009/2010

11.1 The first quarter of the financial year of 2009 saw:

- The 'green shoots' of recovery emerge;
- GDP contracted by 2.4% during last quarter, the largest fall for over 50 years, an improvement in the output-related data was to be somewhat expected.
- Monetary policy loosened further via the extension of the Bank of England's quantitative easing programme, but lending growth is still slow;
- Unemployment rise and earnings growth fall;
- Inflation fall further, but oil prices rise;
- Bond yields and equity prices rise in response to the improved economic outlook;
- Sterling appreciate, but only to a level well below its 2007 peak;
- Activity strengthen to a similar extent in the US, but a much weaker extent in Europe.

11.2 The first quarter saw some encouraging signs that the rate of contraction in the economy had eased considerably. Retail sales grew by 1.0% in April, and while they fell back in May, they remained above March's level. Consumer confidence continued to pick up. Industrial production rose by 0.2% m/m in April, the first rise since November 2007, and the Nationwide house price index rose in May and June, leading to the first quarterly rise since Q4 2007.

11.3 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.

11.4 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.

11.5 Inflationary pressures within the economy continued to reduce in the quarter, although at a slower rate than had been expected. The key factors in this trend are tax rises and increasing oil prices. While the headline rate of CPI inflation fell to 2.2% in May, the reduction was smaller than the consensus expected. RPI inflation fell to -1.1% in May.

Economic Forecast

11.6 The authority Treasury Advisers, Sector, have provided the following forecast;

	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Bank rate	0.50%	0.50%	0.50%	1.00%	1.50%	2.00%	2.50%	3.00%	3.75%	4.25%	4.50%	4.75%
5yr PWLB rate	2.70%	2.75%	2.85%	3.10%	3.30%	3.45%	3.75%	4.00%	4.40%	4.70%	4.85%	5.00%
10yr PWLB rate	3.65%	3.70%	3.70%	3.80%	3.95%	4.15%	4.40%	4.65%	4.85%	5.00%	5.05%	5.20%
25yr PWLB rate	4.40%	4.40%	4.50%	4.50%	4.55%	4.70%	4.80%	4.95%	4.95%	5.10%	5.20%	5.30%
50yr PWLB rate	4.55%	4.55%	4.60%	4.65%	4.75%	4.85%	4.95%	5.05%	5.10%	5.25%	5.25%	5.35%

11.7 This indicates that the Bank Rate will remain at an historical low level until mid-way through 2010, by which time the economy is expected to have improved. For the same reason, PWLB rates are expected to increase over time.

12. <u>TREASURY MANAGEMENT STRATEGY STATEMENT (TMSS)</u>

Annual Investment Strategy

12.1 The Authority's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Authority's investment priorities as follows:

- Security of Capital
- Liquidity

12.2 The Authority will also aim to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term, and only invest with highly credit rated financial institutions using the Sector suggested creditworthiness matrices, including Credit Default Swap (CDS) overlay information provided by Sector.

12.3 A full list of investments held as at 30 July 2009 are shown in Appendix B.

12.4 As illustrated in the economic background section above, investment rates available in the market are at an historical low point. The average level of funds available for investment purposes in the first four months of 2009/10 was £7.172m. 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 and progress on the Capital Programme.

Benchmark	Benchmark Return	Authority Performance	Investment Interest Earned
7 day	0.48%	1.22%	£29,128

12.5 As illustrated, the authority outperformed the benchmark by 74 bp. The Authority's budgeted investment return for 2009/10 is £0.105m, and performance for the year to date indicates that this figure will not be achieved, as a consequence of the fall in interest rates.

Borrowing Strategy

Prudential Indicators:

12.6 It is a statutory duty for the Authority to determine and keep under review the "Affordable Borrowing Limits". The Authority's' approved Prudential Indicators (affordability limits) are outlined in the approved TMSS.

12.7 A full list of the approved limits are included in the budget monitoring report, considered elsewhere on the agenda, which confirms that no breaches of the Prudential Indicators were made in the period to July 2009.

12.8 Sector's target rate for new long term borrowing for the first quarter of 2009/10 was 4.50%. As at the end of July 2009, no new external borrowing had been taken out, however, due to the overall financial position and the underlying need to borrow for capital purposes (the Capital Financing Requirement - CFR), the authority will need to seek new external borrowing during the remainder of the year, the timing of which will be dependent on the cash flow position of the authority, and predictions relating to movements in PWLB/Market rates. As outlined below, interest rates have gradually increased during the quarter across all bands, with the low points in early April and the high points in early to mid June.

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.81	2.47	3.3	4.25	4.46
Date	02/04/2009	02/04/2009	02/04/2009	02/04/2009	02/04/2009
High	1.2	3.2	4.06	4.77	4.85
Date	09/06/2009	12/06/2009	12/06/2009	12/06/2009	02/06/2009
Average	0.970819672	2.797540984	3.708852459	4.562295082	4.656557377

13. <u>SUMMARY</u>

13.1 In compliance with the requirements of the CIPFA Code of Practice of Treasury Management, this report provides Members with a summary report of the treasury management activities during 2008/2009 and an update on the performance so far in the current financial year. As is indicated in this report, none of the Prudential Indicators have been breached and a prudent approach has been taken in relation to investment decisions taken during the year, with priority being given to liquidity and security over yield. Whilst investment returns have reduced from the previous year, as a consequence of the fall in interest rates, the Authority is still achieving returns above the LIBID 7 day rate which is the benchmark return for this type of short term investments.

KEVIN WOODWARD
Treasurer

Investments as at 31st March 2009 – Appendix A							
	Alliance & Leicester	Nationwide B/S		Total invested	Call or Term	Maturity date if Term	Interest rate
Maximum to be invested	£5,000,000	£2,000,000					
Current amount invested	£1,010,000	£2,000,000		£3,010,000			
Balance available for investment	£3,990,000	£0					
Date							
05/01/2009	£1,000,000				T	30/04/2009	2.55%
19/02/2009		£1,000,000			T	20/05/2009	1.95%
03/03/2009		£1,000,000			T	03/06/2009	1.97%
05/03/2009	£10,000				C		1.20%

Investments as at 31st July 2009 – Appendix B							
	Alliance & Leicester	Bank of Scotland	Principality B/S	Total invested	Call or Term	Maturity date if Term	Interest rate
Maximum to be invested	£5,000,000	£5,000,000	£1,000,000				
Current amount invested	£1,110,000	£350,000	£1,000,000	£2,460,000			
Balance available for investment	£3,890,000	£4,650,000	£0				
Date							
18/06/2009	£815,000				C		0.80%
15/07/2009	£295,000				C		0.80%
16/07/2009			£1,000,000		T	17/08/2009	1.00%
20/07/2009		£350,000			C		0.75%