

TITLE:	Annual Report on the Treasury Management Service and Actual Prudential Indicators 2004/05
TO/ON:	Executive 5th December 2005
BY:	Director of Finance
STATUS:	Report
PORTFOLIO:	Learning

STRATEGIC FACTOR CHECKLIST

The Council's Corporate Management Team has confirmed that the Strategic Factor Checklist has been applied to the development of this report, and there are no key issues, over and above those set out in the body of the report, that need to be brought to Members' attention.

1. SUBJECT MATTER AND PURPOSE OF REPORT

1.1. The annual treasury report is a requirement of the Council's reporting procedures and covers the treasury activity for 2004/05. The report also covers the actual Prudential Indicators for 2004/05 in accordance with the requirements of the Prudential Code.

2. BACKGROUND

2.1. The Council's treasury management activities are regulated by a variety of professional codes and statutes and guidance:

- The Local Government Act 2003 (the Act), which provides the powers to borrow and invest as well as providing controls and limits on this activity;
- 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 which may be undertaken (although no restrictions were made in 2004/05);
- Statutory Instrument (SI) 3146 2003, as amended, develops the controls and powers within the Act;
- The SI requires the Council to undertake any borrowing activity with regard to the CIPFA Prudential Code for Capital Finance in Local Authorities;
- The SI 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;
- Under the Act the ODPM has issued Investment Guidance to structure and regulate the Council's investment activities.

2.2. This Council has adopted the CIPFA Code of Practice for Treasury Management in the Public Sector and operates its treasury management service in compliance with this Code and the above requirements. These require that the prime objective of the treasury management activity is the effective management of risk, and that its borrowing activities are undertaken in a prudent, affordable and sustainable basis.

2.3. The Code requires as a minimum the regular reporting of treasury management activities to:

- Forecast the likely activity for the forthcoming year (in the Annual Treasury Strategy Report); and
- Review actual activity for the proceeding year (this report).

2.4. This report sets out:

- A summary of the strategy agreed for 2004/05;
- The Council's treasury position at 31 March 2005;
- The main Prudential Indicators and compliance with limits;
- A summary of the economic factors affecting the strategy over 2004/05;
- The treasury decisions taken and their revenue effects;
- The associated risks of any of these decisions;
- Performance indicators set for 2004/05;
- The performance of these decisions;
- Risk and performance.

2.5. The Strategy Agreed for 2004/05

2.5.1. The Treasury Management Strategy for 2004/05 was approved by members on 24/02/04. It was expected that long-term interest rates would rise during 2004/05, allowing the Authority to carry out debt restructuring during the year. It was anticipated that borrowing of £1.032m would be required to part finance the capital programme.

2.5.2. Investment levels were predicted to rise to £8.8m in 2004/05 and to a maximum of £11.5m over the next three years.

2.6. Treasury Position at 31 March 2005

- The treasury position at the 31 March 2005 compared with the previous year was:

	31 March 2005		31 March 2004	
	Principal	Average Rate	Principal	Average Rate
Fixed Interest Rate Debt	£42.80m	5.88%	£44.70m	5.79%
Variable Interest Rate Debt	£0.01m	4.51%	£0.01m	3.63%
Total Debt	£42.81m	5.88%	£44.71m	5.79%
Fixed Interest Investments	£9.50m	4.86%	£5.50m	4.02%
Variable Interest Investments	£1.63m	4.75%	£2.31m	3.84%
Total Investments	£11.13m	4.84%	£7.81m	3.97%

2.6.1. The change in the treasury position was due to

- Repayment of £1.9m of maturing debt at an average rate of 3.4%.
- Rescheduling of £4.0m at an average rate of 4.75% with a loan of £4.0m at 4.6%.
- An increase in the level of Investments held to £11.13m due to improved cash flow and an increase in retained Capital Receipts available for investment.

2.7. Prudential Indicators and Compliance Issues

2.7.1. The Council is required by the Prudential Code to report the actual prudential indicators after the year end. Appendix A provides a schedule of all the mandatory prudential indicators. Certain of these indicators provide either an overview or a limit on treasury activity, and these are shown below:

	31 March 2005 Actual	31 March 2005 Original Indicator
Net borrowing position	£31.680m	£34.681m
Capital Financing Requirement	£42.565m	£43.759m

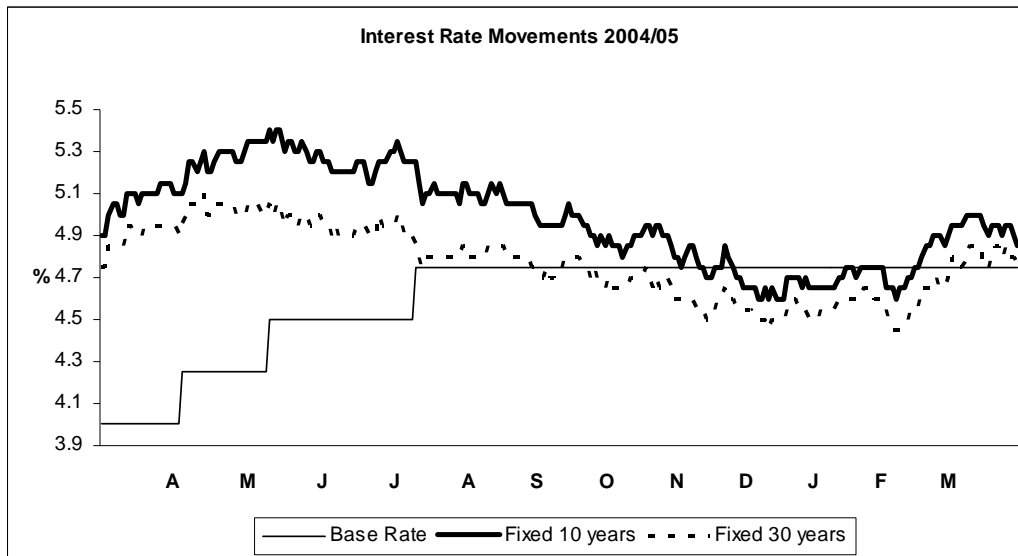
2.7.2. The Capital Financing Requirement (CFR) shows the Council's underlying need to borrow for a capital purpose, and this is a gauge for the Council's debt position shown above. In order to ensure that over the medium term borrowing net of investments will only be for a capital purpose, net borrowing should not, except in the short term, exceed the CFR for 2004/05 plus the expected changes to the CFR over 2005/06 and 2006/07. The table above highlights that the Council has complied with this requirement.

	2004/05
Original Indicator - Authorised Limit	£60.756m
Original Indicator - Operational Boundary	£50.713m
Maximum gross borrowing position during the year	£44.71m
Minimum gross borrowing position during the year	£42.81m

2.7.3. The Authorised Limit is the “Affordable Borrowing Limit” required by s3 of the Local Government Act 2003. The table demonstrates that during 2004/05 the Council has maintained gross borrowing within its Authorised Limit.

2.7.4. The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or over the Boundary is acceptable subject to the Authorised Limit not being breached.

2.8. Economic Background for 2004/05



2.8.1. The rising trend in UK interest rates which commenced in mid-2003 continued during the 2004/05 financial year as the Monetary Policy Committee tightened policy to combat the effects rising economic activity might have upon inflation. These concerns were most in evidence during the early stages of the year and Base Rates were raised in quarter-point steps in May and June to 4.5%. Market pessimism was fuelled by this comparatively aggressive stance and longer-dated money rates rose to in excess of 5% to reflect this.

2.8.2. Official rates were raised again in August to 4.75%, the peak for the year. Thereafter, the MPC adopted a comparatively neutral stance. A steep rise in world oil prices (to in excess of \$50 per barrel) triggered a slowdown in economic activity in industrialised economies, notably the US. This, together with the low domestic inflation environment, caused the Bank of England to adopt a more optimistic view of medium-term inflation prospects, a tack that was seen as a hint that the rate cycle may have peaked. Money market rates adjusted to accommodate this assessment and longer fixed interest rates slipped lower.

2.8.3. Base Rates remained unaltered for the balance of the year but confidence that the rate cycle had peaked was undermined in the last few months of the period. Quoting stronger activity, tighter labour market conditions and rising raw material prices, the Bank of England February 2005 Inflation Report cast some doubt upon the ability of inflation to maintain a subdued performance over the medium term. Money rates rose in reaction to the view that a further tightening of monetary policy was not out of the question.

2.8.4. Long-term interest rates (PWLB rates) tended to track the movements in the money market. A rise in the early part of the year, in response to market interest rate pessimism, was reversed in the autumn and winter of 2004 as weaker economic activity placed downward pressure upon fixed interest rates across the globe. Rates returned to a rising trend in the closing months as the lacklustre performance of key international bond markets combined with a more pessimistic view on rates to drive yields modestly higher.

2.9. Actual Strategy During 2004/05

2.9.1. **Borrowing** – No new loans were taken out during 2004/05.

2.9.2. **Rescheduling** – On 22/11/04 the Council repaid £4.0m at an average rate of 4.75% with breakage costs of £27,489.45. These loans were replaced with £4.0m at 4.6%. As a result annual savings of £1,064 will be made to the General Fund after taking into account of the effect on the HRA.

2.9.3. **Repayment** - On 04/04/04 the Council repaid £1.9m of maturing debt at an average rate of 3.4%.

2.9.4. **Summary of Debt Transactions** – The overall position of the debt activity resulted in a marginal increase in the average interest rate of 0.09%,

2.9.5. Investment Position

- **Investment Policy** – The Council's investment policy is governed by ODPM Guidance, which is implemented in the annual investment strategy approved by Council on 24/02/04. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.
- **Investments Held by The Council** - The Council maintained an average balance of £11.12m and received an average return of 4.67%. The comparable performance indicator is the average 7-day LIBID rate, which was 4.52%. This compares with a budget assumption of £8.80m investment balances at an average interest rate of 4.35%.

2.10. Performance Indicators set for 2004/05

This service has set the following performance

- Debt – Borrowing - Average rate of borrowing for the year compared to average available

As per Para. 2.9.1 above, no new loans were taken out during 2004/05. Therefore this indicator is not applicable.

- Debt – Average rate movement year on year

The average rate of the Authority's debt portfolio has increased from 5.79% to 5.88% during 2004/05. This is mainly due to the repayment of a low coupon rate loan of £1.9m at 3.4%. However, due to the reduction in the overall level of debt from £44.71m to £42.81m, and the debt rescheduling exercise shown in Para. 2.9.2 above, the council's external loan interest payments have reduced by £70,600

- Investments – Internal returns above the 7 day LIBID rate

The Authority achieved an average rate of 4.67% on its investment portfolio in 2004/05. This represents a performance for the year of 0.15% above the average 7-day LIBID rate, which was 4.52%.

2.11. Risk and Performance

- 2.11.1. The Council has complied with all of the relevant statutory and regulatory 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.

2.11.2. The Council is aware of the risks of passive management of the treasury portfolio and, with the support of Butlers, the Council's advisers, has proactively managed the debt and investments over the year. The Council has continued to utilise historically low borrowing costs and has complied with its internal and external procedural requirements. There is little risk of volatility of costs in the current debt portfolio as the interest rates are predominantly fixed, utilising long-term loans.

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

3. RECOMMENDATIONS

3.1. Members are recommended to:

- Approve the actual 2004/05 prudential indicators within the report.
- Note the treasury management stewardship report for 2004/05.

For further information regarding this report contact Aynsley Merritt, Accountant on ext 8375 (a.merritt@derwentside.gov.uk)

Appendix A

Estimated and Actual Treasury Position and Prudential Indicators

	Figures are for the financial year unless otherwise titled in italics	2004/05 Actual £000s	2004/05 Estimate £000s	2003/04 Actual
1	Capital Expenditure	13,085	9,897	
2	Capital Financing Requirement (CFR) at 31 March			
	Housing	29,883	31,370	
	Non Housing	12,682	12,389	
	Total	42,565	43,759	
3	Treasury Position at 31 March			
	Borrowing	42,810	43,491	44,710
	Other long term liabilities	0	0	0
	Total Debt	42,810	43,491	44,710
	Investments	11,130	8,810	7,810
	Net Borrowing	31,680	34,681	36,900
4	Authorised Limit (<i>against maximum position</i>)	44,710	60,756	
5	Operational Boundary	44,710	50,713	
6	General Fund Ratio of financing costs to net revenue stream	1.37%	3.92%	
7	Incremental impact of capital investment decisions on the Band D council tax	0	0	
8	Incremental impact of capital investment decisions on the housing rent levels	0	0	
9	Upper limits on fixed interest rates (<i>against maximum position</i>)	145%	100%	
10	Upper limits on variable interest rates (<i>against maximum position</i>)	0%	30%	
11	Maturity structure of fixed rate borrowing (<i>against maximum position</i>)			
	Under 12 months	0.00%	10.00%	
	12 months to 2 years	0.00%	0.00%	
	2 years to 5 years	0.00%	0.00%	
	5 years to 10 years	11.68%	11.29%	
	10 years and above	88.32%	84.56%	
12	Maximum principal funds invested (<i>against maximum position</i>)	£13.96m	£17.25m	

In addition to the above the Council is required as a Prudential Indicator to:

- Adopt the CIPFA Code of Practice.
- Ensure that over the medium term borrowing will only be for a capital purpose (i.e. net external borrowing is less than the CFR).

The compliance for these indicators are highlighted in the body of the report.

Average Rates for the Comparison Borrowing Table

Average Fixed Maturity Interest Rates for the PWLB over 2004/05

	1	1 1/2	2	2 1/2	3	3 1/2	4	4 1/2	5	5 to 6
Average	4.720%	4.774%	4.825%	4.865%	4.893%	4.916%	4.936%	4.943%	4.956%	4.969%
High	5.100%	5.150%	5.250%	5.300%	5.350%	5.350%	5.400%	5.400%	5.400%	5.400%
Low	4.350%	4.400%	4.500%	4.500%	4.500%	4.550%	4.550%	4.550%	4.550%	4.550%

	6 to 7	7 to 8	8 to 9	9 to 10	10 to 15	15 to 20	20 to 25	25 to 30	Over 30
Average	4.976%	4.984%	4.987%	4.988%	4.987%	4.952%	4.884%	4.818%	4.773%
High	5.400%	5.400%	5.400%	5.400%	5.400%	5.300%	5.200%	5.100%	5.100%
Low	4.600%	4.600%	4.600%	4.600%	4.600%	4.600%	4.550%	4.500%	4.450%

Average Variable Rates for the PWLB over 2004/05

1-M Rate	3-M Rate	6-M Rate
4.747%	4.825%	4.920%