HEREFORDSHIRE COUNCIL

TREASURY MANAGEMENT ACTIVITIES 2005/2006

PORTFOLIO RESPONSIBILITY: CORPORATE STRATEGY AND FINANCE

CABINET **28TH SEPTEMBER, 2006**

Wards Affected

Countywide.

Purpose

To note the Council's Treasury Management activities for the period 1st April, 2005 to 31st March, 2006 and the outturn of Prudential Indicators for the year 2005/06.

Key Decision

This is not a key decision.

Recommendation

THAT the report detailed in Appendix 1 be noted.

Reasons

The reporting of the past financial year's performance is a requirement of the Council's Treasury Management Policy.

Considerations

1. A detailed report is attached at Appendix 1 with the following key points specifically drawn to the attention of Cabinet:

   - With regard to the transactions for the financial year 2005/06, the cost of borrowing was below the budget and the investment income was above the budget (Section 2 and 3 of the report refers).
   - The return on internally managed investments exceeded the index benchmark for 2005/06 (Section 3 of the report refers).
   - The net return on externally managed funds was marginally below the index benchmark for 2005/06 (Section 3 of the report refers).
   - The treasury limits and prudential indicators were complied with during 2005/06 (Section 6 of the report refers).

Further information on the subject of this report is available from
Mrs. Sonia Rees, Director of Resources on 01432 383519

Risk Management

Risk is managed in accordance with the Treasury Management Policy Statement approved by Cabinet in February 2006.

Consultees

None identified.

Background Papers

None identified.

APPENDIX 1

TREASURY MANAGEMENT REPORT 2005/06

PURPOSE

The purpose of this report is to advise Cabinet of the Council's Treasury Management Activities for 2005/06.

1. INTRODUCTION AND BACKGROUND

1.1 The Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management 2001 was adopted by this Council in February 2002 and this Council fully complies with its requirements. The primary requirements of the Code are the:-

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the Cabinet of an annual strategy report for the year ahead and an annual review report of the previous year.
- Delegation by the Council 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 An Internal Audit Review in March 2006 noted that the treasury management system has a good system of control.

1.4 This annual treasury report covers:

- the Council's Borrowing Transactions 2005/06;
- the Council's Investment Transactions 2005/06;
- the Strategy for 2005/06;
- the economy in 2005/06 (borrowing and investment rates in 2005/06);
- compliance with treasury limits and Prudential Indicators;

1.5 Effective treasury management can make a useful contribution to helping achieve the Council's strategic objectives.

2. THE COUNCIL'S BORROWING TRANSACTIONS 2005/06

2.1 The following summary gives information relating to the Council's long-term borrowing transactions in 2005/06.

Long-term Borrowing	£
As at 1st April 2005	67,719,702
New Borrowing (see paragraph 2.3)	18,000,000
Less: Repayments	(3,423,523)
As at 31st March 2006	**82,296,179**

2.2 The Public Works Loan Board (PWLB) remains the main source of long-term borrowing for the Council. In addition to PWLB loans the Council have also borrowed from the money market in the form of two LOBO (Lender Option, Borrowing Option) loans.

2.3 After careful consideration of interest rate forecasts, expected capital spending, repayment profile and having regard to the existing debt, loans were taken during 2005/06 as follows:

Date	Loan Type	Lender	Amount £	Period (years)	Interest Rate %
20/05/05	Fixed Maturity	PWLB	3,000,000	4	4.40
20/05/05	Fixed Maturity	PWLB	3,000,000	29	4.45
21/11/05	Fixed Maturity	PWLB	5,000,000	28	4.25
23/01/06	Fixed Maturity	PWLB	7,000,000	41	3.70
			18,000,000		

2.4 Rates of interest available during the year for PWLB Fixed Rate – Maturity (25 to 30 years) loans ranged from 3.85% to 4.80%. From December 2005 it became possible to borrow funds from the PWLB for up to 50 years.

2.5 The cost of borrowing in 2005/06 was £911,311 less than the budget, mainly due to slippage on the Capital Programme leading to lower debt repayment in the year, and new borrowing at low interest rates. Interest payments totalled £3,301,451. The average rate of interest paid on borrowings during the year was 4.43% compared to 4.62% in 2004/05, reflecting the new borrowing at low interest rates.

2.6 The longer term debt at 31st March 2006 falls due for repayment as follows:

Long-term Debt Profile **Within**	**£**	**% of total debt**
1 year	12,443,384	15
1 – 5 years	9,473,191	11
5 – 10 years	1,688,708	2
10 – 15 years	3,862,385	5
15 years and over	54,828,511	67
TOTAL	**82,296,179**	**100**

2.7 In addition to the external borrowing identified above, the Council has a bank overdraft facility with its bankers, National Westminster Bank plc, of £6,000,000, which was used on a limited basis during the year. This was used in replacement of any short-term borrowing of amounts less than £100,000 where it would not be cost effective to borrow through the money market.

2.8 The Council's aim is to maintain a nil cleared balance, as far as possible, in low-interest bearing accounts. In practice this is hard to achieve because some payments are made directly in to the bank. However, such sums are not significant in overall terms. The average daily bank balance for 2005/06, on which debit and credit interest is calculated was £5,835 in credit, indicating we were extremely close to achieving our target. **Annex A** illustrates the balances for 2005/06.

3. THE COUNCIL'S INVESTMENT TRANSACTIONS 2005/06

3.1 **Internally Managed Investments** – The Council manages its in-house investments with the institutions listed in the Council's approved lending list. The Council placed investments for a range of periods from overnight to 364 days. The length depended on factors such as cash flow requirements and if it was viewed that interest rates would change.

3.2 During the year the interest rate earned on internally managed funds varied between 4.49% and 4.96% and the average daily investment managed internally was £34,836,135. The actual daily investments ranged from £21,193,636 to £48,830,000, which illustrates how much the temporary cash flow fluctuates throughout the year. The temporary short-term investment transactions for 2005/06 are summarised as follows:

Internally Managed Investments	**£**	**£**
As at 31st March 2005		25,990,000
Investments made during year (266 transactions)	2,148,495,586	
Less: Investments recalled during year	(2,144,065,586)	4,430,000
As at 31st March 2006		**30,420,000**

3.3 The level of funds that were available for investment increased during the year, due to budget underspends and slippage on the Capital Programme.

3.4 The average interest rate achieved on internally managed funds was 4.65%, which compares favourably with the generally accepted yardstick of the average 7-Day London Inter-Bank Bid (LIBID) rate (uncompounded) of 4.54%. The Council's return on temporary investments largely mirrored the prevailing base rate. **Annex B** compares the average interest rate earned on internally managed funds, the 7-day LIBID rate, borrowing rates offered by the PWLB and the Bank of England Base Rate.

3.5 **Externally Managed Investments** – Council funds of £7,469,030 (as at 31st March 2006) continued to be managed externally by Investec Asset Management Ltd (Investec). The fund management agreement between the Council and Investec defines the limits for maximum duration of investments for the fund and the Counterparty criteria and exposure limits.

3.6 The average net return for the year was 4.45% and the net income earned is then added to the fund. Investec's return was marginally below the benchmark of the average 7-day LIBID rate (compounded) of 4.64%. The Council continues to monitor Investec's performance on a monthly basis.

3.7 The Council achieved well above its investment income budget of £705,000 in 2005/06 (as summarised below). This was primarily due to slippage on the Capital Programme and cash flow advantages on delays in spending to budget, together with increased interest rates.

Summary of Investment Income	£	£
Internally Managed Funds		1,639,161
Externally Managed Funds (net)		328,070
		1,967,231
Less: transfers to Schools	(222,602)	
Interest payments to trusts etc.	(96,104)	
		(318,706)
Interest Received 2005/06		**1,648,525**

4. THE STRATEGY FOR 2005/06

4.1 The treasury strategy for 2005/06 was based on a view of a weakening of the rate of growth in the U.K. economy precipitated by a downturn in household spending, in conjunction with a weakening of the housing market. Inflation was expected to rise due to increases in oil and commodity prices which would cause the Monetary Policy Committee (MPC) to be on alert for increases in the prices of goods and services and pay inflation. The forecast for base rate was that there would probably be one final increase in base rate to 5.00% in quarter 1 of 2005. After that, the MPC would be on hold until the reduction in economic activity gathered momentum and inflation pressures subsided to enable base rate to be cut to 4.50% by the end of 2005/06.

4.2 The U.S. Federal Bank was expected to continue its policy of a gradual increase in its interest rate (still only 2.25% at the beginning of 2005) as the economy continued to expand at a robust rate, though less strong than in 2004. The Eurozone growth rate was expected to improve, but only weakly, and so the rates were expected to remain unchanged at 2.00% for probably most of 2005/06 until the economy improved. Inflation in all three areas was expected to be contained.

4.3 The effect on interest rates for the U.K. was therefore expected to be as follows:

Shorter-term interest rates - The “average” City view anticipated that the peak of growth in the U.K., U.S. and world economies had passed in 2004 and that moderating growth rates in 2005 would lead to only a slight decrease in U.K. base rate from an average of 5.00% in 2006 to reach about 4.75% by the end of 2007.

Longer-term interest rates - The view on longer-term fixed interest rates was that long term PWLB rates would be fairly stable around the 4.75% level for most of the financial year (equivalent to a long term gilt yield of approximately 4.60%).

4.4 All of the above was taken into account in the strategy agreed by Cabinet, that was:

- That the expectation for falling base rates in the future was so strong that the drawing of cheaper, shorter term funding later in the year for some of the 2005/06 borrowing requirement would assist in lowering debt servicing costs. The risk was that leaving longer term borrowing to later years could lead to higher longer-term interest costs.

- That the risks around shorter term variable interest rates are such, when compared to historically low long-term funding costs, that the Council will maintain a stable, longer term portfolio by drawing longer term fixed rate funding.

- The Council operated both borrowing and investment portfolios and as a consequence 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 balanced treasury risk.

5. THE ECONOMY IN 2005/06

5.1 **Shorter-term interest rates –** Base rate started 2005/06 at 4.75%, having been unchanged at this level since August 2004. It fell to 4.50% in August 2005 and remained at that level for the rest of the year. The strong growth of consumer expenditure and housing prices in 2004 was less evident during 2005 though the housing market did pick up to recover later in the year and in early 2006. High oil prices and major increases in utility prices reduced spending power. GDP growth picked up from a low point of 1.7% year on year in quarter two to 2.3% in quarter one 2006. This was still slightly below the long term average annual growth rate of about 2.5%.

5.2 **Longer-term interest rates –** The PWLB 25-30 year rate started the year at 4.75% and fell to a low of 3.85% before rising back to a new peak of 4.25% at the end of the year. 50-year gilts were launched and on 7 December, the PWLB introduced new PWLB borrowing maturity periods longer than 25-30 years and up to a maximum of 45-50 years. This longest band started at a rate of 4.20% (compared to 4.30% for 25-30 year borrowing) and the rate bottomed at 3.70% in late January before ending the year at 4.15%.

6. COMPLIANCE WITH TREASURY LIMITS AND PRUDENTIAL INDICATORS

6.1 During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Policy Statement and annual Treasury Management Strategy. The outturn for the Prudential Indicators is shown in **Annex C**. The Prudential Indicators set out are recommended by the CIPFA Prudential Code for Capital Finance.

6.2 The outturn of the Capital Programme was provided for Cabinet as part of the Integrated Annual Outturn Report 2005/06. The capital programme outturn for 2005/06 totalled £31,845,249 compared to an original budget of £37,130,299, which represents a decrease of £5,285,050 or 14%. This is due to new schemes and new sources of funding being identified, project slippages and deferment of schemes into future years.

6.3 The original Prudential Borrowing allocated for 2005/06 was £7,607,000. The outturn for the use of Prudential Borrowing was £5,131,000 as set out below.

2005/06 Prudential Borrowing Allocation		£7,607,000
Add: Slippage from 2004/05		£2,011,000
Less: Slippage into 2006/07	(£4,225,000)	
Funded by available SCE(R)	(£125,000)	
Relinquished re Queenswood Car Park	(£137,000)	(£4,487,000)
Actual Prudential Borrowing in 2005/06		£5,131,000