

WYRE FOREST DISTRICT COUNCIL

CABINET MEETING
28TH SEPTEMBER, 2006

Report on Treasury Management Service and Actual Prudential Indicators 2005/2006

OPEN	
COMMUNITY STRATEGY THEME	Internal Organisational Theme
CORPORATE THEME:	Improving Corporacy & Performance
KEY PRIORITY:	Financial and Asset Management
STRATEGY:	Final Accounts
CABINET MEMBER:	Cllr. John Champion
RESPONSIBLE OFFICER:	Head of Financial Services
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APPENDIX	Estimates and Actual Treasury Position and Prudential Indicators

1. PURPOSE OF REPORT

The annual treasury report is a requirement of the Council's reporting procedures and covers the treasury activity for 2005/06. The report also covers the actual Prudential Indicators for 2005/06 in accordance with the requirements of the Prudential Code.

2. RECOMMENDATIONS

The Cabinet is asked to **DECIDE:**

- 1. The actual 2005/06 Prudential Indicators detailed within the report and summarised in Appendix A be approved.**
- 2. The Treasury Management Service Report for 2005/06 be noted.**
- 3. The revised Counterparty List for Investment purposes be approved as detailed in paragraph 3.9.3. of the report.**

3. BACKGROUND

- 3.1 The Council undertakes capital expenditure on long term assets. These activities can be funded immediately through capital receipts, capital grants etc., although any residue which cannot be immediately paid for will give rise to a borrowing need. This borrowing need will be charged to revenue over a number of years. The area of capital expenditure activity is regulated by the CIPFA Prudential Code, which requires actual outturn to be reported in the following areas:

- Capital expenditure;
- Capital Financing Requirement;

- Debt;
- Ratio of financing costs to net revenue stream.

The remaining indicators are included to make the annual reporting comprehensive.

3.1.2 Part of the Council's treasury activities is to address any borrowing need, either through borrowing from external bodies, or utilising temporary cash resources within the Council. The wider treasury activities also include managing the Council's cash flows, its previous borrowing activities and the investment of surplus funds. These activities are structured to manage risk foremost, and then optimise performance. This area of activity is regulated by the CIPFA Code of Practice on Treasury Management.

3.1.3 Wider information on the regulatory requirements is shown in Section 12.

3.2 The Council's Capital Expenditure and Financing 2005/06

This forms one of the required prudential indicators (a list of all mandatory indicators is at Appendix A), and shows total capital expenditure for the year and how this was financed.

	2005/06 Actual £'000	2005/06 Estimate £'000
Total capital expenditure	4,205	8,807
Resourced by:		
Capital receipts	2,247	6,171
Capital grants	1,374	1,948
Revenue	39	0
Unfinanced capital expenditure (additional need to borrow)	545	688

3.3 The Council's Overall Borrowing Need

3.3.1 The Council's underlying need to borrow is called the Capital Financing Requirement (CFR). This figure is a gauge for the Council's debt position and represents 2005/06 and historic net capital expenditure which has not yet been charged to revenue. The process for charging the capital expenditure to revenue is a statutory requirement and is called the Minimum Revenue Provision (MRP). The Council has the option to charge more than the statutory MRP each year through Voluntary Revenue Provision (VRP). The Council's CFR for the year is shown below, and represents a key prudential indicator.

Capital Financing Requirement	31 March 2006 Actual £'000	31 March 2006 Original Indicator £'000
Opening balance 1 April 2005	926	926
Plus unfinanced capital expenditure	545	688
Less MRP/VRP*	(112)	(93)
Closing balance 31 March 2006	1,359	1,521

- * A Voluntary Revenue Provision is made to link the annual charge to revenue with the life of the asset.

3.4. Treasury Position at 31st March 2006

- 3.4.1 Whilst the Council's gauge of its underlying need to borrow is the CFR, the Head of Financial Services can manage the Council's actual borrowing position by either borrowing to the CFR, choosing to utilise some temporary cash flow funds instead of borrowing (under-borrowing), or borrowing for future increases in the CFR (borrowing in advance of need). During 2005/06 the Head of Financial Services managed the debt by the use of temporary cashflow funds and did not borrow.

Treasury position	31st March 2006		31st March 2005	
	Principal	Average Rate	Principal	Average Rate
Fixed Interest Rate Debt	£0.047m	6.21%	£0.049m	6.21%
Variable Interest Rate Debt	-	-	-	-
Total Debt	£0.047m	6.21%	£0.049m	6.21%
Fixed Interest Investments	£20.930m	4.79%	£20.290m	4.64%
Variable Interest Investments(included in fixed)	-	-	-	-
Total Investments	£20.930m	4.79%	£20.290m	4.64%
Net borrowing position	(£20.883m)		(£20.241m)	

3.5 The Strategy Agreed for 2005/06

- 3.5.1 The strategy provided for 2005/06 was approved by Council on 23rd February 2005 – Council Minute 773. Full details are contained within the Budget Reports 2005/2008 (Pink Book).

3.6 Actual Debt Management Activity During 2005/06

- 3.6.1 **Borrowing** - During 2005/06 the Head of Financial Services utilised temporary cashflow funds and did not borrow.

- 3.6.2 **Rescheduling** – No rescheduling of debt took place during 2005/06.

- 3.6.3 **Repayment** – During 2005/06 Council repaid £2,000 at an average rate of 6.21%.

3.7 Prudential Indicators and Compliance Issues

- 3.7.1 Some of the required prudential indicators provide either an overview or specific limits on treasury activity. These are shown below:

- 3.7.2 **Net Borrowing and the CFR** - In order to ensure that borrowing levels are prudent, over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. Net borrowing should not therefore, except in the short term, exceed the CFR for 2005/06 plus the expected changes to the CFR over 2006/07 and 2007/08. Since the Council's investments considerably exceed the

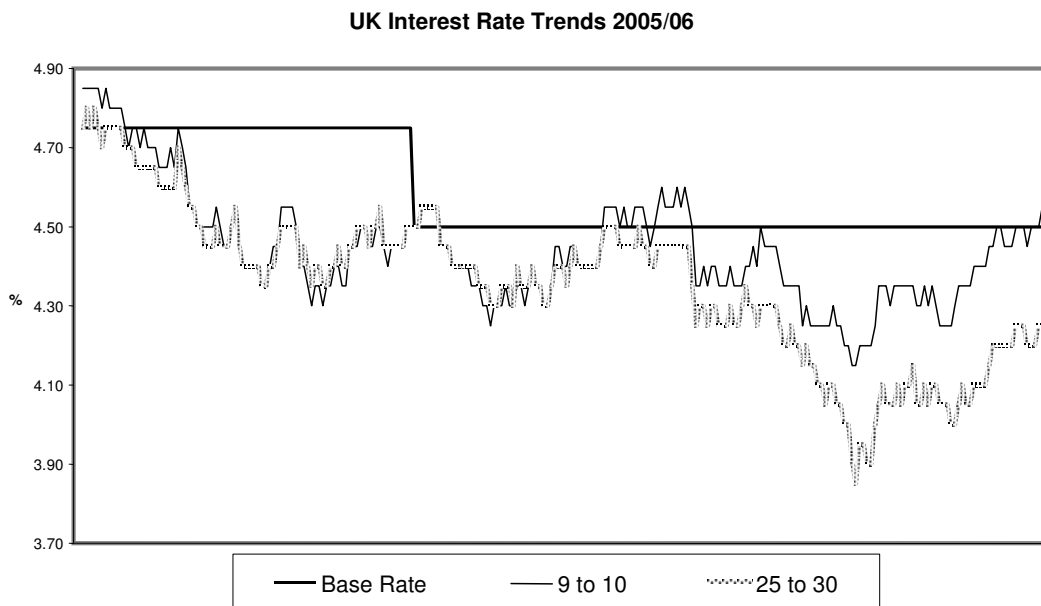
minimal amount borrowed, the net position is well below the CFR. The table below highlights that the Council has complied with this requirement.

	31st March 2006 Actual £'000	31st March 2006 Original Indicator £'000
Net borrowing position	(20,883)	(23,610)
Capital Financing Requirement	1,359	1,521

- 3.7.3 **The Authorised Limit** - The Authorised Limit is the "Affordable Borrowing Limit" required by Section 3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2005/06 the Council has maintained gross borrowing within its Authorised Limit.
- 3.7.4 **The Operational Boundary** – 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.
- 3.7.5 **Actual financing costs as a proportion of net revenue stream** - This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2005/06
Original Indicator - Authorised Limit	£6.00m
Maximum gross borrowing position during 2005/06	£0.425m
Original Indicator - Operational Boundary	£5.50m
Average gross borrowing position during 2005/06	£0.036m
Original Indicator Financing costs as a proportion of net revenue stream	(9.37%)
Actual Financing Costs as a proportion of net revenue stream	(10.03%)

3.8 Economic Background for 2005/06



- 3.8.1 UK interest rates remained within a tight range during the 2005/06 financial year. Base rates opened the period at 4.75% and ended a quarter-point lower at 4.5%. In spite of this, longer-dated fixed interest rates fluctuated more, rising and falling in response to notable shifts in market expectations.
- 3.8.2 The year started on a pessimistic note. The apparent failure of consumer spending and the housing market to respond to the Bank of England's policy base rate rises – in train since November 2003 – supported suggestions that base rates had further to rise before peaking in the later stages of 2005.
- 3.8.3 These concerns faded quickly, in spite of an unfavourable international background where the rise in US interest rates showed no signs of abating. UK economic data suggested the economy was slowing down faster than had been assumed just a few months earlier. As evidence of this slowdown gathered, expectations of a return to a more stable monetary policy strengthened.
- 3.8.4 Base rates were finally cut by 0.25% to 4.5% in August and hopes of further reductions in the autumn and spring 2006 were widespread. However optimism faded as signs of a recovery in UK activity increased whilst the international interest rate backdrop deteriorated.
- 3.8.5 Long-term Public Works Loan Board (PWLB) fixed interest rates followed an erratic path. Some declines were seen in the first half of the year as concerns about the combination of economic activity and inflation faded. However, it was technical factors that proved to be the main driving force behind long-term fixed interest rates. These comprised strong flows of international funds to bonds and very heavy UK pension fund demand for fixed income assets.

3.8.6 Technical demand came to a head in late 2005 and early 2006. New bond supply to the UK market was insufficient to satisfy this and long-term fixed interest rates were driven to historic lows. This trend was seen most clearly for very long interest rates and the rate on the new 45-50 year PWLB loan (introduced in early December 2005) reached a low of 3.7%.

3.8.7 The downward trend did not continue. Strong demand associated with international fund inflows and UK pension fund investment weakened as investors chose not to chase yields to yet lower levels. In addition to this, fears that overseas interest rates had a good deal further to rise in the face of strengthening activity in the US, Japan and the Euro-zone encouraged a switch away from bond investments. As a result, long-term interest rates rebounded in February and March but still ended the year some 0.25% below where they had started.

3.9 Investment Position

3.9.1 **Investment Policy** – The Council's investment policy is governed by guidance issued by the former Office of the Deputy Prime Minister (ODPM), that has been implemented in the annual investment strategy approved by Council on 28th February 2006. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

3.9.2 **Investments Held by Fund Managers** The Council did not use Fund Managers during 2005/06.

3.9.3 Counterparty List – Schedule of Authorised Financial Institutions

The Council has a maximum of approximately £30 million of temporary investments during a financial year. At the present time the Council uses ratings from all three rating agencies – Fitch Moody's and Standard and Poors – to determine its counterparty list. Limits range from £2m to £10m and investments have been made for longer than one year. The Head of Financial Services having analysed the Council's Treasury Management Strategy believes that it needs amending to ensure that all counterparties are treated in a similar way according to their ratings. The consistency will ensure that the Council's Investment Strategy will be robust under scrutiny.

At the present time, the Council's criteria splits banks into two categories – "Clearing Banks" and "Other Banking Institutions". Ratings are used to decide who is eligible for the two groups. Building Societies are selected (and limits applied) using their assets as criteria, not ratings. It is suggested that this method is changed to ensure that **all** Banks **and** Building Societies are treated in the same way. Clearing Bank status does not provide investors with any increased protection and therefore should not be used as a separate criteria.

The use of ratings gives a better all-round view of an institution and therefore this is the method we would recommend for Council use. These changes will not only ensure a more consistent approach to selecting organisations and applying limits to them, but will also give increased flexibility with regards to levels of investments for non Clearing Banks.

It is recommended that the Counterparty List detailed below is adopted.

The Head of Financial Services will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. This criteria is separate to that which chooses Specified and Non-Specified investments as it selects which counterparties the Council will choose rather than defining what its investments are.

- **Banks and Building Societies** – the Council will use banks and building societies which have at least the following Fitch or equivalent ratings :
 - **Short Term – F1**
 - **Long Term – A-**
 - **Individual/Financial Strength – C** (Fitch/Moody’s only)
 - **Support – 3** (Fitch only)
- **Building Societies** – in addition to societies who meet the criteria above, the Council will also use those with assets in excess of £1 billion.
- **Bank Subsidiary and Treasury Operations** – the Council will use these where the parent bank has the necessary ratings outlined above.
- **Money Market Funds – AAA rated**
- **UK Government** (including DMO)
- **Local Authorities, Parish Councils etc**

The time limits for institutions on the Council’s Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):

	Fitch	Moody’s	Standard & Poors	Money Limit	Time Limit
Upper Limit Category	F1+ / AA-	P-1 / Aa3	A-1+ / AA-	£8m	5 years
Middle Limit Category	F1 / A-	P-1 / A3	A-1 / A-	£5m	3 years
Lower Limit Category	-	-	-	£3m	364 days
Other Institution Limits	-	-	-	£8m	n/a

Note These limits cover both Specified and Non-Specified Investments. The limit is also subject to no more than 25% of outstanding investments being placed with any one institution at any one time.

1. The Upper and Middle Limit categories will include both banks and building societies.
2. The Lower Limit category will be for unrated bank subsidiaries (according to criteria outlined above) and unrated building societies with assets in excess of £1bn.
3. The Other Institution Limit will be for other local authorities, the Debt Management Account Deposit Facility (DMADF) and Money Market Funds. These are all considered high quality names – although not always rated – and therefore will likely have the same limit as the Upper Category.

These limits will cover both Specified and Non-Specified Investments.

- 3.10 **Investments Held by The Council** - The Council had an average investment balance of £26.685 million and received an average return of 4.79% with the comparable Performance Indicator being 4.54%. This compares with a budget assumption of an average investment balance of £26.325 million at an average interest rate of 4.50%.

External investment interest and other interest received during the year was £1,311,970 compared to the Revised Budget of £1,219,960. This surplus is primarily due to achieving a return in excess of the average 7 day rate and slippage on the Capital Programme.

3.11 Performance Indicators set for 2005/06

This service has achieved the following performance :-

- Investments – Internal returns (4.79%) above the 7 day London Interbank Bid (LIBID) rate (4.54%)

3.12 Regulatory Framework, Risk and Performance

- 3.12.1 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 2005/06);
- 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 Chartered Institute of Public Finance and Accountancy (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 former ODPM has issued Investment Guidance to structure and regulate the Council's investment activities.

- 3.12.2 The Council has complied with all of the above 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.

3.12.3 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 its treasury position.

3.12.4 Shorter-term 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.

4. KEY ISSUES

4.1 Key Issues are contained within paragraph 3 – background.

5. FINANCIAL IMPLICATIONS

5.1 The Financial Implications are contained with paragraphs 3.2, 3.3.1 and 3.4.1 and paragraph 3.10.

6. LEGAL AND POLICY IMPLICATIONS

These are contained within Paragraph 3.12.1.

7. RISK MANAGEMENT

7.1 Risk Management is contained within paragraphs 3.12.2, 3.12.3 and 3.12.4.

8. CONCLUSION

8.1 The Cabinet is asked to approve the recommendations contained within paragraph 2.

9. CONSULTEES

9.1 Corporate Management Team.

10. BACKGROUND PAPERS

10.1 Treasury Management 2005/2008 approved by Council on 23rd February 2005. Council Minute 773.

Estimated and Actual Treasury Position and Prudential Indicators

	Figures are for the financial year unless otherwise titled in italics	2005/06 Actual		2005/06 Original Indicator		2004/05 Actual	
1	Capital Expenditure	£4.205m		£8.807m		£3.767m	
2	Capital Financing Requirement (CFR) at 31 March	£1.359m		£1.521m		£0.926m	
3	Treasury Position at 31 March						
	Borrowing	£0.047m		£0.047m		£0.049m	
	Other long term liabilities	-		-		-	
	Total Debt	£0.047m		£0.047m		£0.049m	
	Investments	£20.930m		£25.000m		£20.290m	
	Net Borrowing	(£20.883m)		(£23.610m)		(£20.241m)	
4	Maximum Debt (Actual) compared to Authorised Limit (Original Indicator)	£0.425m		£6.0m		Figures available from 2005/06 onwards	
5	Average Debt compared to Operational Boundary (Original Indicator)	£0.036m		£5.5m			
6	Ratio of financing costs to net revenue stream	(10.03%)		(9.37%)		(10.91%)	
7	Incremental impact of capital investment decisions on the Band D council tax	£2.45		£3.65		£3.76	
8	Proportion of fixed interest rates investments (Actual) compared to upper limits on fixed interest rates (Original Indicator)	90.1%		100%		92.9%	
9	Proportion of variable interest rates investments (Actual) compared to upper limits on variable interest rates (Original Indicator)	9.9%		22%		7.1%	
10	Maturity structure of fixed rate borrowing (Actual) compared to the range of approved percentages (Original Indicator)	Max	Min	Max	Min	Max	Min
		%	%	%	%	%	%
	Under 12 months	0	0	100	0	0	0
	12 months to 2 years	0	0	100	0	0	0
	2 years to 5 years	0	0	100	0	0	0
	5 years to 10 years	0	0	100	0	0	0
	10 years and above	100	0	100	0	100	0
11	Funds invested for longer than 364 days (Actual) compared to maximum principal funds invested for longer than 364 days (Original Indicator)	£10.7m		£25m		nil	

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 Council's compliance with these indicators is highlighted in the body of the report.