

**WYRE FOREST DISTRICT COUNCIL****CABINET MEETING**  
**27<sup>TH</sup> SEPTEMBER, 2007****Report on Treasury Management Service and**  
**Actual Prudential Indicators 2006/2007**

| COMMUNITY STRATEGY   |  | OPEN   |
|----------------------|--|--|
| THEME                |  | Internal Organisational Theme                                    |
| CORPORATE THEME:     |  | Improving Corporacy & Performance                                |
| KEY PRIORITY:        |  | Financial and Asset Management                                   |
| STRATEGY:            |  | Treasury Management  |
| CABINET MEMBER:      |  | Cllr. John Campion   |
| RESPONSIBLE OFFICER: |  | Head of Financial Services                                       |
| CONTACT OFFICER:     |  | Keith Bannister Ext. 2100<br>Keith.bannister@wyreforestdc.gov.uk |

**1. PURPOSE OF REPORT**

- 1.1 The annual treasury report is a statutory requirement of the Council's reporting procedures. It covers the treasury activity for 2006/07 and the actual Prudential Indicators for 2006/07.
- 1.2 The report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through Regulations issued under the Local Government Act 2003.

**2. RECOMMENDATIONS****The Cabinet is asked to DECIDE:**

1. **The actual 2006/07 Prudential Indicators detailed within the report be approved.**
2. **The Treasury Management Service Report for 2006/07 be approved.**
3. **The revised Counterparty List for Investment purposes be approved as detailed in paragraph 4.11 of the report.**

**3. EXECUTIVE SUMMARY**

- 3.1 During 2006/07 the Council complied with its legislative and regulatory requirements. The actual prudential indicators for the year, with comparators, are as follows:

| <b>Actual Prudential Indicators</b>   | <b>2005/06</b> | <b>2006/07</b> |
|---|----------------|----------------|
|   | <b>£'000</b>   | <b>£'000</b>   |
| Actual Capital Expenditure  | 4,205          | 4,615          |
| Capital Financing Requirement   | 1,359          | 1,485          |
| Financing Costs as a proportion of net revenue stream (this is a negative indicator as the Authority is in a net investment position) | (10.03%)       | (9.70%)        |

3.2 The Head of Financial Services also confirms that prudential borrowing was only undertaken for a capital purpose and the Statutory borrowing limit, the Authorised Limit, was not breached.

3.3 At 31st March 2007, the Council's external debt was £43,847 (£47,385 at 31 March 2006) and its investments totalled £26.557m (£20.930m at 31st March 2006).

#### **4. BACKGROUND**

##### 4.1 Introduction

This report summarises:

- the capital activity for the year
- how this activity was financed
- the impact on the Council's indebtedness for capital purposes
- the Council's overall treasury position
- the reporting of the required prudential indicators
- a summary of interest rate movements in the year
- debt activity
- investment activity

##### 4.2 Council's Capital Expenditure and Financing 2006/07

4.2.1 The Council undertakes capital expenditure on long term assets. These activities may either be:

- Financed immediately through capital receipts, capital grants, direct revenue financing etc.; or
- If insufficient financing is available the expenditure will give rise to a borrowing need

4.2.2 Part of the Council's treasury activities is to address this 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. Wider information on the regulatory requirements is shown in paragraph 4.10.

- 4.2.3 The actual capital expenditure forms one of the required prudential indicators. The table below also shows how this was financed.

| £'000   | 2005/06<br>Actual | 2006/07<br>Estimate | 2006/07<br>Actual |
|---|-------------------|---------------------|-------------------|
| <b>Total capital expenditure</b>  | <b>4,205</b>      | <b>5,564</b>        | <b>4,615</b>      |
| Resourced by:   |                   |                     |                   |
| Capital receipts  | 2,247             | 3,413               | 3,134             |
| Capital grants  | 1,374             | 1,109               | 942               |
| Revenue   | 39                | 629                 | 181               |
| <b>Unfinanced capital expenditure<br/>(additional need to borrow)<br/>Relates to Vehicle, Equipment<br/>&amp; Systems Renewals Schedule</b> | <b>545</b>        | <b>413</b>          | <b>358</b>        |

#### 4.3 The Council's Overall Borrowing Need

- 4.3.1 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. The Council's CFR for the year is shown below, and represents a key prudential indicator.

| CFR (£'000)  | 31 March<br>2006<br>Actual | 31 March<br>2007<br>Original<br>Indicator | 31 March<br>2007<br>Actual |
|--|----------------------------|---|----------------------------|
| Opening balance  | 926                        | 1,359                                     | 1,359                      |
| Add: unfinanced capital expenditure  | 545                        | 413                                       | 358                        |
| Less: VRP*   | (112)                      | (241)                                     | (232)                      |
| <b>Closing balance</b><br><b>Relates to Vehicle, Equipment &amp;<br/>Systems Renewals Schedule</b> | <b>1,359</b>               | <b>1,531</b>                              | <b>1,485</b>               |

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

- 4.3.2 The Balance Sheet CFR is reviewed annually by the Head of Financial Services, in liaison with Butlers (the Council's Treasury Consultants), and kept at a manageable level.

#### 4.4 Treasury Position at 31st March 2007

- 4.4.1 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 2006/07 the Head of Financial Services managed the debt by the use of temporary cashflow funds and did not utilise external borrowing. The treasury position as at 31<sup>st</sup> March 2007 compared with the previous year was:

| Treasury position                                | 31st March 2006   |              | 31st March 2007   |              |
|--|-------------------|--------------|-------------------|--------------|
|  | Principal         | Average Rate | Principal         | Average Rate |
| <b>Total Debt</b>                                | <b>£0.047m</b>    | <b>6.21%</b> | <b>£0.044m</b>    | <b>6.08%</b> |
| Fixed Interest Investments                       | (£20.930m)        | 4.79%        | (£26.557m)        | 4.90%        |
| Variable Interest Investments(included in fixed) | -                 | -            | -                 | -            |
| <b>Total Investments</b>                         | <b>(£20.930m)</b> | <b>4.79%</b> | <b>(£26.557m)</b> | <b>4.90%</b> |
| <b>Net investment position</b>                   | <b>(£20.883m)</b> |              | <b>(£26.513m)</b> |              |

#### 4.5 Prudential Indicators and Compliance Issues

- 4.5.1 Some of the required prudential indicators provide either an overview or specific limits on treasury activity. These are shown below:
- 4.5.2 **Net Borrowing Levels 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 2006/07 plus the expected changes to the CFR over 2007/08 and 2008/09. 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.

|                                | 31 March 2006<br>Actual £'000 | 31 March 2007<br>Original<br>Indicator £'000 | 31 March 2007<br>Actual £'000 |
|--------------------------------|-------------------------------|--|-------------------------------|
| <b>Net investment position</b> | <b>(20,883)</b>               | <b>(26,955)</b>                              | <b>(26,513)</b>               |
| <b>CFR</b>                     | <b>1,359</b>                  | <b>1,531</b>                                 | <b>1,485</b>                  |

- 4.5.3 **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 2006/07 the Council has maintained gross borrowing within its Authorised Limit.

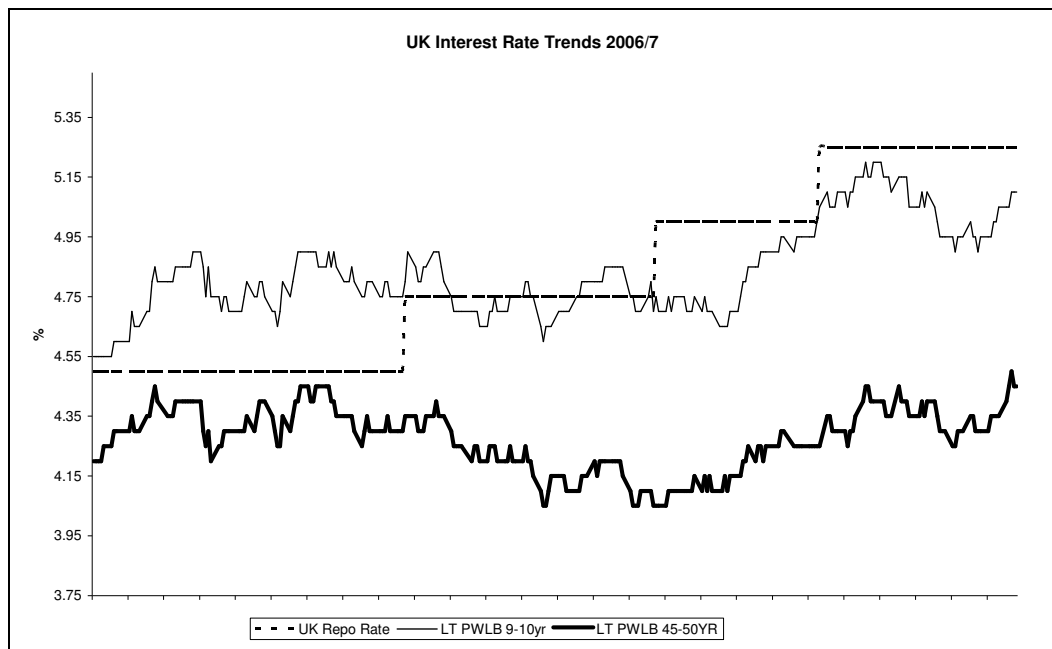
4.5.4 **The Operational Boundary** – The Operational Boundary is the expected borrowing position of the Council during the year, and periods where the actual position is either below or over the Boundary is acceptable subject to the Authorised Limit not being breached.

4.5.5 **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.

|   | 2006/07         |
|---|-----------------|
| <b>Original Indicator - Authorised Limit</b>                        | <b>£3.00m</b>   |
| <b>Maximum gross borrowing position during 2006/07</b>              | <b>£247,659</b> |
| <b>Original Indicator - Operational Boundary</b>                    | <b>£2.50m</b>   |
| <b>Average gross borrowing position during 2006/07</b>              | <b>£29,329</b>  |
| <b>Minimum gross borrowing position</b>                             | <b>0</b>        |
| <b>Actual Financing Costs as a proportion of net revenue stream</b> | <b>(9.70%)</b>  |

4.6 Economic Background for 2006/07

4.6.1 All treasury activity is directed by both the current market interest rates and expectations of future movements, for instance longer term investment rates for one and two years will reflect anticipated movements in the Monetary Policy Committee (MPC) Bank Base Rate (currently referred to as the Bank of England’s UK Repo Rate). Longer term borrowing rates are influenced by inflation and demand and supply considerations.



- 4.6.2 The 2006/07 financial year featured a rising trend in short term interest rates as policy makers and financial markets responded to the twin effects of strengthening economic activity and rising inflation.
- 4.6.3 The optimism that prevailed in the first few months of 2006 had evaporated by the beginning of the new financial year. The rebound in economic activity since 2005 proved more robust than consensus expectations. In addition, external pressures on consumer price inflation had continued to escalate. While short-term interest rates remained steady in the first few months of the year, there were growing expectations that a rise in official interest rates would eventually materialise.
- 4.6.4 The first hike in the Bank Base Rate from 4.5% to 4.75% was announced in August 2006 as the Bank of England responded to the deteriorating inflation outlook. The economy's slow response to monetary policy tightening, a less than favourable international backdrop and concerns that deteriorating inflation expectations at home would drive prices higher prompted additional rate hikes. Two quarter point increases in the base rate were announced in November 2006 to 5% and January 2007 to 5.25%. Further tightening measures were anticipated by the market, and attractive investment opportunities prevailed to year end.
- 4.6.5 Long-term interest (Public Works Loans Board (PWLB)) rates charted an erratic course but the overall trend was towards higher levels. Deteriorating inflation expectations on the domestic and international fronts, in reaction to strong growth on a global basis, was the principal force driving yields higher. Strong technical demand for bonds, courtesy of the rebalancing of pension fund portfolios in favour of fixed income assets, was insufficiently strong to counter the rise in yields. Occasional rallies in the gilt-edged market caused dips in rates and presented favourable borrowing opportunities. But these were short-lived and by the close of the year, yields were trading close to the highest levels seen since early 2005.

4.7 The Strategy Agreed for 2006/07

- 4.7.1 The strategy provided for 2006/07 was approved by Council on 1st March 2006 – Council Minute C.107 (11.2).
- 4.7.2 Full details of the approved strategy can be found in the Report to Cabinet on 16<sup>th</sup> February 2006. In summary the planned treasury activity was as follows:

Borrowing

1. To fund the Capital Programme requirements from the Council's own capital receipts and grants.
2. The Vehicle, Equipment and Systems Renewals to be funded by means of medium term borrowing and direct revenue financing.
3. To fund any projected overdrawn balances by appropriate borrowing.

Investments

1. To lend funds which are surplus (after cash flow requirements have been taken into account) on a longer term basis where short term interest rates are projected to fall or show little upwards movement.
2. Should investment requirements exceed £10million and market conditions are likely to be favourable, to appoint suitable Investment Managers at the appropriate time in accordance with the Council's Standing Orders Relating to Contracts.
3. Alternatively, should short term interest rates be forecast to move noticeably upwards, to lend surplus funds on a shorter term basis, unless materially higher long term interest rates can be obtained, when surplus funds should be lent on a longer term basis.

#### 4.8 Investment Position

4.8.1 **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 1<sup>st</sup> March 2006. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

4.8.2 **Resources** – The Council's longer term cash balances comprise primarily revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources, excluding other day to day cashflow balances, comprised:

| Balance Sheet Resources<br>(£'000) | 31 March 2006 | 31 March 2007 |
|------------------------------------|---------------|---------------|
| General Fund Revenue Balance       | 4,538         | 4,101         |
| Earmarked reserves                 | 1,550         | 2,183         |
| Provisions                         | 49            | 45            |
| Usable capital receipts            | 15,307        | 19,280        |
| <b>Total</b>                       | <b>21,444</b> | <b>25,609</b> |

4.8.3 **Investments Held by Fund Managers** The Council did not use Fund Managers during 2006/07.

4.8.4 **Investments Held by The Council** - The Council does not have the expertise or resources to actively use a wide range of investment products and therefore performance tends to be more stable but lower over the longer term than for professionally managed funds (whose performance may fluctuate more). The Council maintained an average balance of £30.996m and received an average return of 4.9%. The comparable performance indicator is the average 7 day London Interbank Bid (LIBID) rate, which was 4.84%. This compares with a budget assumption of £29.360m investment balances at 4.9% interest rate. External Interest received totalled £1,520,160 compared to the revised budget of £1,431,710.

4.8.5 The Council holds investments on behalf of a number of related bodies including Parish Councils and Kidderminster Educational Foundation.

4.9 Performance Indicator set for 2006/07

This service has set the following performance indicator :-

- Investments – Internal returns (4.9%) above the 7 day London Interbank Bid (LIBID) rate (4.84%)

4.10 Regulatory Framework, Risk and Performance

4.10.1 The Council's treasury management activities are regulated by a variety of professional codes, 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 2006/07);
- Statutory Instrument (SI) 3146 2003, as amended, developed 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 former ODPM (now CLG) has issued Investment Guidance to structure and regulate the Council's investment activities.

4.10.2 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.

4.10.3 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. 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.

4.10.4 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.

#### 4.11 Counterparty List – Schedule of Authorised Financial Institutions

The Council has an average of up to £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. Butlers (the Council's Treasury Advisors) have recently indicated that Moody's have undertaken an adjustment of its financial institution ratings. In the main, the outcome of their changes results in long term ratings being raised and financial strength ratings lowered. Butlers have advised that, although the changes have upset the previously simple method of comparing ratings from the three agencies, the changes do not render the further use of Moody's ratings redundant. Instead, they recommend a Lowest Common Denominator (LCD) approach to assigning limits. This will nullify the more extreme differences that certain counterparties have in the ratings they have from the three agencies.

Limits currently 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 following advice from Butlers, believes that it needs amending to ensure that all counterparties are treated in a similar way according to their ratings, taking into account the new LCD approach to assigning limits. The consistency will ensure that the Council's Investment Strategy will be robust under scrutiny.

The use of ratings gives a better all-round view of an institution and therefore this is the method adopted for Council use. These changes ensure a consistent approach to selecting organisations and applying limits to them.

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** – taking into account the LCD approach, 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):

|                          | <b>Fitch</b> | <b>Moody's</b> | <b>Standard &amp; Poors</b> | <b>Money Limit</b> | <b>Time Limit</b> |
|--------------------------|--------------|----------------|-----------------------------|--------------------|-------------------|
| Upper Limit Category     | F1+ / AA-    | P-1 / Aa3      | A-1+ / AA-                  | £8m                | 3 years           |
| Middle Limit Category    | F1 / A-      | P-1 / A3       | A-1 / A-                    | £5m                | 2 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.

## **5. KEY ISSUES**

- 5.1 Key Issues are contained within paragraph 4 – background.

## **6. FINANCIAL IMPLICATIONS**

- 6.1 The Financial Implications are contained within paragraphs 4.2, 4.3.1, 4.4.1 and 4.8.4.

## **7. LEGAL AND POLICY IMPLICATIONS**

- 7.1 Legal and Policy Implications are contained within paragraph 4.10.1.

## **8. RISK MANAGEMENT**

7.1 Risk Management is contained within paragraphs 4.10.2, 4.10.3 and 4.10.4.

**9. CONCLUSION**

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

**10. CONSULTEES**

10.1 Corporate Management Team  
Councillor John Campion, Leader of the Council

**11. BACKGROUND PAPERS**

11.1 Treasury Management Strategy 2006/07 approved by Council on 1st March 2006  
Council Minute C.107 (11.2).