Agenda Item No:		**Report No:**	
Report Title:	**Annual Treasury Management Report 2006/2007**		
Report To:	**Cabinet**	**Date:**	**23 July 2007**
Lead Councillor:	**Councillor Ann De Vecchi**		
Ward(s) Affected:	**All**		
Report By:	**Director of Finance and Community Services**		
Contact Officer(s):	**Stephen Osborne, Principal Accountant**		

Purpose of Report:

To present Cabinet with a report on the Treasury Management activities of the Council in the year 2006/2007.

Officers Recommendation(s):

1 To receive the Annual Treasury Management Report 2006/2007.

Reasons for Recommendations

1 Treasury Management is a key control for the Council and in accordance with the Code of Practice on Treasury Management in the Public Services, Cabinet receives a report on each year's activities.

Information

2 Introduction and Background

2.1 Treasury management in local government is regulated by the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management in the Public Services. The Council has adopted the Code and 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.

2.2 Treasury Management in this context is described as

"The management of the Council'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."

2.3 This annual report covers the following areas of Treasury Management:

- the Council's year end portfolio position;
- performance measurement;
- borrowing strategy and outturn 2006/2007;
- compliance with treasury limits and Prudential Indicators;
- investments and outturn 2006/2007;
- debt rescheduling.

3 Year end portfolio position

3.1 The Council's debt and investment position at the beginning and the end of the year was as shown below. 'PWLB' refers to Public Works Loan Board.

	31 March 2006		**31 March 2007**	
	Principal £m	**Rate %**	**Principal £m**	**Rate %**
Fixed Rate Funding				
- PWLB	9.00	4.63	6.00	4.68
- Market	5.00	4.09	5.00	4.09
	14.00	4.44	11.00	4.41
Variable Rate Funding				
- PWLB/Market	0.00	n/a	0.00	n/a
Total Debt	**14.00**	**4.44**	**11.00**	**4.41**
Investments				
- In-house	15.33	4.70	14.89	5.34
- ADC Debenture	0.02	n/a	0.02	n/a
Total Investments	**15.35**	**4.70**	**14.89**	**5.34**

3.2 The Council's long term debt has fallen by £3.0m following the maturity of a PWLB loan on 1 April 2006.

3.3 The 'Market' Debt shown in the table above at 31 March 2007 is represented by a £5m long term loan. The latter is a 'Lenders Option Borrowers Option (LOBO)'. The LOBO, which was advanced in April 2004, is at 4.09% for the first four years, rising to 4.5% for the next four years. From year 9 onwards there are four-yearly reviews. If the lender wants a higher rate at the review dates the Council can repay the loan at no extra cost. If no change is sought, the Council must renew at 4.5% for the following four year period. Accounting requirements are such that this loan is treated as an 8 year fixed interest loan for reporting purposes.

3.4 The Council manages all of its investments internally and currently does not place investments with external fund managers.

4 Performance Measurement

4.1 Whilst investment performance criteria have been developed and universally accepted, debt performance indicators continue to be a more problematic area with the traditional average portfolio rate of interest acting as the main guide (as incorporated in the table in section 3).

4.2 A straight comparison of debt costs with other authorities will not necessarily be a good indication to performance because the average debt rate will reflect:

- the timing and financing of past expenditure
- the debt structure
- the limitations the debt structure poses for rescheduling
- the current strategy for debt management in the medium to long term

5 The Strategy for 2006/2007

5.1 The Expectation for Interest Rates

The interest rate view incorporated within the Council's Treasury Strategy Statement was based upon officers' views, advice from the Council's Treasury advisers and a selection of City forecasts.

(a) Short-term interest rates (up to 12 months). At the time of writing the strategy the base rate was 4.50% and was expected to remain on hold until the end of the first quarter of 2006. The rate was then expected to fall to 4.00% by the end of the fourth quarter 2006 and to edge up by 0.25% in each quarter of 2007 and to end the year at 4.75%.

The risk to the forecast was that the cuts in rates could occur earlier than the forecast suggested, although not necessarily affect the timing of the first upward move in the first quarter of 2007.

(b) Long-term interest rates (in excess of 12 months). The new 50 year rate was expected to remain at 4% until the fourth quarter of 2006 when it was forecast to rise to 4.25% with a further increase to 4.5% in the second quarter of 2007.

Similarly the 25-30 year PWLB rate was expected to remain at 4.25% until the fourth quarter of 2006 when it was forecast to rise to 4.50% with a further increase to 4.75% in the second quarter of 2007.

The 10 year PWLB rate was expected to stay at 4.25% in the first two quarters of 2006 and then rise to reach 4.50% in the third quarter of 2006 with a further rise to 4.75% in the first quarter of 2007.

(c) The structure of the Council's long-term borrowing is such that its exposure to fluctuations in interest rates is limited in the short term to the investment side of the treasury portfolio.

5.2 The agreed Treasury Strategy

(a) In 2004/2005, the introduction of the Prudential Framework for Local Authority Capital Finance had given the opportunity to secure the Council's borrowing requirement in the medium term by utilising new borrowing arrangements with the PWLB, previous restrictions having been removed from 1 April 2004. In response to this, long-term borrowing had been undertaken in April 2004 which anticipated the Council's borrowing needs in respect of its future capital programme through to 2007/2008.

(b) The Strategy for 2006/2007 was that it was not expected that there would be a need for any new long-term borrowing. The repayment of a fixed rate loan of £3m, due in April 2006, would be funded from cash held as temporary investments. Temporary borrowing might be needed on occasion during the year for cash flow reasons.

6 Outturn for 2006/2007 – Borrowing

6.1 **Shorter-term interest rates** – Base Rate started 2006/07 at 4.5%, having been unchanged at this level since August 2005. The Bank of England Inflation Report of May 2006 marked a watershed in as much as the Monetary Policy Committee (MPC) switched from a loosening bias on interest rates to a tightening bias. The MPC suspicions that official data had been under recording the strength of economic growth were vindicated by retrospective adjustments (increases) to annual growth figures extending back as far as 2001 in the first quarter of 2006 Gross Domestic Product (GDP) figures. These revisions also increased the fourth quarter of 2005 and the first quarter of 2006 GDP growth figures up from 0.6% to 0.7% quarter on quarter. This tipped previous expectations of an underperforming UK economy over into one that was running at or above its trend rate of growth. Previous expectations of cuts in Base Rate in 2006 evaporated and were replaced by the reverse expectation i.e. at least one, if not two increases of 0.25% by the end of 2006. Bank Rate accordingly rose to 4.75% in August 2006 and then to 5.0% in November.

This was then followed by another rate increase in January to 5.25% which was a shock to both the financial markets and forecasters and immediately sparked inferences that the MPC had had access to some bad news on the inflation front, which was not available to the markets at that time, before it took that decision. These fears were confirmed soon after by the news that Consumer Price Inflation (CPI) had increased to 3.0% in December, a whisker away from the MPC having to write a letter of explanation to the Chancellor (if it had gone over 3.0%). The annual growth rate also hit 3.0%, the highest in two years, in the fourth quarter of 2006 adding to confirmation that the recent increases in Base Rate had done little to dampen the economy and stoking expectations that Base Rate would have to rise even further.

6.2 **Longer-term interest rates** – The PWLB 45-50 year rate started the year at 4.20% (25-30 year at 4.30%) and fell to a low of 4.05% several times in late September to early November (25-30 year low was 4.20% in

September and November). The high point for 45-50 year was 4.50% in late March 2007 (25-30 year had several highs of 4.65% in January to March 2007) before finishing the year at 4.45% (25-30 year 4.65%). The sustained rise in long term rates in the fourth quarter of 2006 and the first quarter of 2007 was underpinned by the rise in inflation expectations.

6.3 In line with the Strategy, only occasional temporary borrowing took place during 2006/2007 as shown in the table below.

	Lender	Principal £	Rate %	Date From	Date to
	New Borrowings in Year				
	Short-term				
1	South Lanarkshire Council	1,000,000	4.820	30/08/06	01/09/06
2	Sub-total	1,000,000			
	Short-term borrowing at 1 April 2006 repaid in year				
3	Nil				
	Long-term borrowing at 1 April 2006 repaid in year				
4	PWLB	3,000,000	4.550	01/04/04	01/04/06

6.4 The average rate of interest payable in 2006/2007 was 4.41%, reflecting the relatively low rates of the PWLB loans which the Council had borrowed at the start of April 2004. As comparative performance indicators, average PWLB interest rates for 2006/2007 were:

1 year	5.13%
9-10 year	4.83%
25-30 year	4.44%
45-50 year	4.27%

7 Compliance with Treasury Limits

During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Policy Statement and annual Treasury Strategy Statement. The outturn for the Prudential Indicators is shown in Appendix 1.

8 Outturn for 2006/2007 – Investments

8.1 The Council managed its investments in-house and invested with the institutions listed in the authority's standard lending list. Investments were made in accordance with the Council's approved investment strategy. The authority invested for a range of periods from overnight to 2 years dependent on the authority's cash flows and the interest rates on offer.

8.2 The results of the investment activity undertaken by the Council during 2006/2007 are shown below. This table shows the average investment for the year whereas the portfolio position table in paragraph 3.1 shows the investments at 31 March 2007.

Form of management	Average Investment in the year £m	Gross Rate of Return %	Benchmarks	
			7 Day LIBID %	3 Month LIBID %
Internally Managed	19.264	4.86	4.84	4.99

8.3 No institutions in which investments were made showed any difficulty in repaying investments and interest in full during the year.

9 Debt Rescheduling

The agreed Treasury Strategy for the year did not anticipate any debt rescheduling activity in 2006/2007, and no rescheduling was undertaken.

Financial Appraisal

10 This is included in the paragraphs above.

Environmental Implications

11 I have completed the Environmental Implications questionnaire and this Report is exempt from the requirement because it is a progress report.

Risk Management Implications

12 I have completed the Risk Management questionnaire. This report does not require a risk assessment because it is reporting the outcome of activity carried out in the year. However, it should be noted that Treasury Management has two main risks:

i) fluctuations in interest rates can result in a reduction in income from investments or an increase in interest payable on outstanding debt

ii) a counterparty to which the Council has lent money fails to repay the loan at the required time

13 These risks are mitigated by the Treasury Strategy and the Investment Strategy. Both of these strategies for 2006/2007 were prepared on the basis that all treasury management activity is carried out in order to minimise interest payments and achieve the optimum return on investments commensurate with the proper levels of security and liquidity.

Background Papers

14 CIPFA Code of Practice on Treasury Management

Sector Treasury Services – Annual Treasury Report Template 2006/2007

Appendices

15 Appendix 1 – Prudential Indicators outturn 2006/2007

Appendix 1 – Prudential Indicators outturn 2006/2007

The table below compares the outturn of each prudential indicator with the approved estimate for 2006/2007. Only those prudential indicators which are relevant to the Treasury Strategy are shown – the outturn of the other prudential indicators was reported as part of the Capital Programme outturn report.

Reference	Indicator	2006/07 estimate	2006/07 outturn
	AFFORDABILITY		
PR 3	Estimates of the impact of capital investment decisions on the Council Tax (Band D per annum)	£24.20	£24.17
PR 4	Estimates of the impact of capital investment decisions on Housing Rents (per week)	£3.18	£2.55
PR 7	Estimate of non-HRA capital financing requirement as at the end of each financial year	£2.989m	£3.051m
PR 8	Estimate of HRA capital financing requirement as at the end of each financial year	£10.138m	£9.809m
	(note – the above indicators are shown within the Capital Programme report to Cabine tin June 2007 along with PR 1, PR2 , PR 5 and PR 6 which are not directly relevant to Treasury Management)		
	Authorised limit for external debt		
PR 9	- Borrowing	£22.45m	the maximum outstanding borrowing on any one day was £11.34m
PR 10	- Other Long Term Liabilities	£0.05m	
PR 11	- Total	£22.50m	
	Operational boundary for external debt		
PR 12	- Borrowing	£17.00m	
PR 13	- Other Long Term Liabilities	£0.05m	
PR 14	- Total	£17.05m	
	PRUDENCE		
PR 15	Net external borrowing below capital financing requirement	met	met
PR 16	Adoption of CIPFA Code of Practice for Treasury Management	met	met
PR 17	The upper limit on fixed interest rate exposures	-1369%	-281%
PR 18	The upper limit on variable interest rate exposures	1469%	381%
		Upper/lower limit	
	Maturity structure of fixed rate borrowing		at 31/3/2007
PR 19/20	- under 12 months	70%/0%	27.3%
PR 21/22	- 12 months and within 24 months	70%/0%	0%
PR 23/24	- 24 months and within 5 years	75%/0%	0%
PR 25/26	- 5 years and within 10 years	75%/0%	45.4%
PR 27/28	- 10 years and above	75%/0%	27.3%
	(note – PR19 to 28 calculated as amount of projected borrowing that is fixed rate maturing in each period as a percentage of total projected borrowing that is fixed rate)		
PR 29	Upper limit for principal sums invested for more than 364 days	50%	31.7%

The variations in PR3 and PR4 arose as a result of variations in the capital programme in 2006/2007 which were explained in the Capital Programme outturn report to Cabinet in June 2007.