Report to: **Council**

Subject: **Annual Treasury Activity Report 2005/2006**

Date: **14 June 2006**

Author: **Head of Finance**

1. PURPOSE OF REPORT

To inform Members of the Annual Treasury Activity Report as required by the Treasury Management Strategy.

2. BACKGROUND

Gedling Borough Council fully complies with the requirements of the CIPFA Code of Practice on Treasury Management 2001, which has been formally adopted by the Council. 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.

- The 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 Council of an annual Treasury Management Strategy Statement (TMSS) for the year ahead, and an Annual Report detailing the Treasury activities for 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.

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.”

This **annual treasury report** covers:

- the Council’s current treasury position;
- performance measurement;
- the strategy for 2005/06;
- the economy in 2005/06
- borrowing and investment rates in 2005/06
- the borrowing outturn for 2005/06;
- compliance with treasury limits and Prudential Indicators;
- investment outturn for 2005/06;

3. ANNUAL TREASURY ACTIVITY REPORT 2005/06

This report combines two previous reports, in respect of treasury borrowing and treasury investment. It covers:

- **The Council’s current treasury position**

  The Council’s debt and investment position at the beginning and end of the year is shown at Appendix 1.

- **Performance Measurement**

  One of the key changes in the revision of the Code of Practice has been the formal introduction of performance measurement relating to investments, debt and capital financing activities. Whilst investment performance criteria have been well 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

  The use of benchmarks such as the 12-month LIBID for investments may be inappropriate for local authorities with relatively small cash balances, as they are generally able to place funds for only short periods and often at lower rates. The 7-day LIBID rate is considered more appropriate as the relevant benchmark for Gedling’s investments. The 7 day uncompounded LIBID rate for 2005/06 was 4.54% and the Council’s in-house managed funds achieved an overall equated rate of 4.70%, out performing the benchmark by 0.16%.

Gedling's relatively limited number of borrowing transactions and the absence of average borrowing rates for model portfolios, means the Council needs to develop benchmarks in this problematic area. Similar to investments, the market does produce a 7-day LIBOR rate for the annual cycle and this is suggested as the benchmark that temporary borrowing should be measured against. For 2005/2006, Gedling's average temporary borrowing rate was 4.75% against a 7 day LIBOR rate of 4.65%. Our performance under performed against the benchmark by 0.1%, but the Council has only taken three short term loans which covered in total a period of only 11 days.

The Council's treasury management borrowing performance is in reality dominated by its long term borrowing activity. The amount to be borrowed is directed by the Council's capital expenditure plans approved as part of the annual budget, therefore, performance is best measured by looking at the timing of long term borrowing which can be controlled by use of temporary treasury activity.

As detailed later in this report, the Council took long term borrowing at 3.7% which turned out to be the lowest rate on offer during the 2005/2006 financial year performance which, therefore, could not be bettered. For the forthcoming year performance measurements are being developed which will measure the timing of the Council's long term borrowing by comparison to the annual interest rate cycle for relevant long term loan periods. It is felt that this will be a growing area of the Council's treasury activity and for 2006/2007 quarterly performance monitoring will be introduced.

- **The Strategy for 2005/06**

The Treasury Management Strategy Statement (TMSS) for 2005/06 was based the view of a weakening of the rate of growth of GDP in the UK 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 to be on alert for second round inflation effects in increases in the prices of goods and services and pay inflation. The forecast for base rate was that there would probably be enough steam in the upswing of the economic cycle to warrant one final increase in base rate to 5.0% in quarter 1 of 2005. After that, the MPC would be on hold until the downswing in economic activity gathered momentum and inflation pressures subsided to enable base rate to be cut to 4.5% by the end of 2005/06.

The U.S. Fed was expected to continue its policy of a gradual increase in the Fed 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 European Central Bank was therefore forecast to leave rates unchanged at 2.0% for probably most of 2005/06 until the economy showed some stronger signs of stirring. Inflation in all three areas was expected to be well contained.

The effect on interest rates for the UK was therefore expected to be as follows:

Shorter-term interest rates - The "average" City view anticipated that the peak of growth in the UK, US 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 5.0% 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%).

The agreed TMSS based upon the above forecast was that:

best value could be achieved by borrowing short term at variable rates to minimise borrowing costs, but that if fixed PWLB rates should fall significantly, then a trigger point of about 4.5% was set for considering new fixed rate long term borrowing.

The risks intrinsic in the shorter term variable rates are such, when compared to historically relatively low long term fixed funding, which may be achievable in 2005/06, that the Council will maintain, a stable, longer term portfolio by drawing longer fixed rate funding at a marginally higher rate than short term rates.

Against this background, caution was to be adopted and a pragmatic approach taken to any changing circumstances.

- **The Economy in 2005/06**

Shorter-term interest rates – Base rate started 2005/06 at 4.75%, having been unchanged at this level since August 2004. It fell to 4.5% 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 became positively anaemic during 2005 though the housing market did pick up to recover a bit later in the year and in quarter 1 2006. High oil prices and major increases in utility prices reduced spending power and negatively impacted sentiment. Claimant count unemployment increased each month

during the year while manufacturing output was actually in recession for the first two quarters of 2005 before staging a recovery. GDP growth picked up from a low point of 1.7% y/y in Q2 to 2.3% in Q1 2006 i.e. still slightly below the long term average growth rate of about 2.5% p.a.

Longer-term interest rates – The PWLB 25-30 year rate started the year at 4.750% and fell to a low of 3.85% before rising back to a new peak of 4.25% at the end of the year. Fifty year gilts were launched in 2005 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%.

- **Borrowing and Investment rates in 2005/06**

12-month bid rates: The 12-month LIBID rate started the year at a high point for the year of just over 5.0% but then fell and made a number of brief sorties down to around 4.35% in July to October before market expectations of one possible imminent further cut in base rate to 4.25% finally vanished. By the end of 2005/06, the rate had climbed steadily back up to 4.70% as market expectations geared themselves up for an increase in base rate as being the next move on the back of the recovery of GDP growth to near the long term average and concerns around inflation.

7 day bid rate – the 7-day bid rate considered more appropriate for Gedling's investments, given our relatively small cash balances, started the year at 4.5% and ended at 4.54%.

Longer-term interest rates – The PWLB 25-30 year rate started the year at 4.75% and then fell into a range of 4.30 – 4.50% for most of 2005 after mid May. However, long gilt yields plunged to levels unprecedented in recent history in late January and the 25-30 year rate bottomed out at 3.85% before rising back to a new peak of 4.25% at the end of the year. A major innovation in 2005/06 was the introduction by the Government of the longest maturity period gilts since the 1960s, namely for 50 years. The first issue of £2.5bn on 26.5.05 was followed by further similar sized tranches in July, December and February. The PWLB took its cue from the 7 December issue to introduce at the same time new PWLB borrowing for 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%. The phenomenally low rates above were widely interpreted as having been caused by unusually high demand for long gilts from non UK institutions including oil rich and Asian countries buying financial assets with their cash mountains.

- **The Borrowing Outturn for 2005/06**

  The Council undertook new borrowing during 2005/06 totalling £6m as detailed in Appendix 1. The Council took the opportunity to borrow £3m at the low rate of 3.7%, referred to in the paragraph above, in readiness to cover the borrowing requirement for the 2006/07 capital programme.

- **Compliance with Treasury Limits and Prudential Indicators**

  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 Management Strategy Statement. The outturn for the Prudential Indicators is shown at Appendix 2.

- **Investment Outturn for 2005/06**

  The Council manages its investments in-house and invests with the institutions listed in the Council's approved lending list. The Council invests for a range of periods, dependent on the Council's cashflows, its interest rate view and the interest rates on offer.

Investments have been made in accordance with the in-house investment strategy agreed in the TMSS below:

> *The Council's in-house managed funds are mainly cashflow derived, however, there is a core balance available, which may be invested over a 2-3 year period. Investments will be made with reference to the core balance and cashflow requirements, and the outlook for short-term interest rates (ie. for investments up to 12 months).*
>
> *Sector is forecasting base rate to be on a falling trend from 5% in Q1 and Q2 of 2005 to 4.5% in Q1 and Q2 of 2006. The Council therefore seek to lock into longer period investments at higher rates before this fall starts, for some of the element of its investment portfolio representing its core balance.*
>
> *The Council used its business reserve accounts and short-dated deposits (1-3 months) in order to benefit from the compounding of interest at potentially higher rates.*
>
> *The Council identified 5% as an attractive "trigger" rate for 1 year lending, and 5.5% for 2-3 year lending.*

Investment Activity 2005/06

In accordance with the above strategy, towards the end of 2004/05 a core balance of £2 million was identified, and two 364-day investments were made, achieving rates of 4.94% and 5.12% respectively. These investments stood the Council in good stead going into 2005/06, as rates eased back in anticipation of the first base rate cut towards the end of 2005. As described earlier in this report the Council undertook borrowing during 2005/06 at advantageous rates in readiness for financing the 2006/07 capital programme, this has resulted in further fixed term investments during the year. These investments, together with the reinvestment of the core balance towards the end of 2005/06, resulted in a total of £5.5m in fixed term investments at 31/03/06. Each investment was placed at times and rates advised by Sector and for terms between 6 months and 364 days.

The remainder of the investment activity for 2005/06 was cashflow derived and business reserve accounts and short dated deposits where used throughout the year.

A summary of the Councils investments during 2005/06 can be found at Appendix 1 and show that the actual average interest rate received by the Council was 4.70% which compares favourably to the 7 Day LIBID benchmark rate of 4.54%.

4. RECOMMENDATION

Members are asked to:

i. Approve the above Annual Treasury Activity Report

ii. To note the outturn in respect of the Treasury Limits and Prudential Indicators, shown at Appendix 2.