Report to: **Council**

Subject: **Annual Treasury Activity Report 2006/07**

Date: **20 June 2007**

Author: **Head of Corporate Services**

1. PURPOSE OF REPORT

To inform Members of the Annual Treasury Activity Report as required by the Treasury Management Strategy, and the outturn in respect of the Prudential Indicators.

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."

3. ANNUAL TREASURY ACTIVITY REPORT 2006/07

(3.1) 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.

(3.2) Performance Measurement

One of the key changes in the revised Code of Practice in 1996 was 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 2006/07 was 4.84% and the Council's in-house managed funds achieved an overall equated rate of 5.51%, out performing the benchmark by 0.67%. As a further comparison, the 3 month uncompounded LIBID rate was 4.99%.

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 2006/07, Gedling's average temporary borrowing rate was 4.76% against a 7 day LIBOR rate of 4.94%. Performance was favourable against the benchmark despite the Council taking only 5 short term loans covering a total period of only 10 days. This is due to all but one of the five loans being taken in the early part of the year, before interest rates rose.

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 £4m of additional long term borrowing during the year. Due to favourable rates, this was predominantly in anticipation of the requirement for the 2007/08 capital programme. In addition, the Council rescheduled two existing loans of £1m each, following advice from Sector Treasury Services. This allowed the Council to benefit from more favourable rates and to generate a discount of £28,000.

(3.3) The strategy for 2006/07

The Treasury Management Strategy Statement (TMSS) for 2006/07 was based a view of the rate of growth of GDP in the UK only recovering weakly during 2006/07, and remaining at a below trend level of 2% in 2006. This was primarily due to weak consumer expenditure, undermined by major increases in gas and electricity prices and another spike in oil prices, plus a curtailing of the strong increases in public sector expenditure of previous years. House price inflation had fallen back to very low levels and there were no major concerns on inflation in general (recent spikes in some process would fall out of the index eventually). In addition, continuing increases in the Fed rate in the US would reduce economic growth to 2.5% in 2006, while growth in the Euro area was also expected to continue weak, but to rise a little. Given this overall quite weak outlook, the forecast for Bank Rate was that there would need to be two cuts from 4.5% to 4% by the end of 2006 in order to stimulate growth in the economy. This would then be followed by quarterly 0.25% increases in Bank Rate in quarters 1 to 3 of 2007 once the economy had regained its trend growth rate of around 2.5% to 2.75% per annum.

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 weak growth in the UK, US and EU would lead to a decrease in Bank Rate from 4.5% to either 4.25% or 4% by the end of 2006, and then edge up.

Longer-term interest rates - The view on longer-term fixed interest rates was that long term PWLB rates would rise by about 0.25% to end 2006/07 at around 4.75%.

The agreed TMSS based upon the above forecast was that:

The borrowing strategy for 2006/07 should be to take long dated borrowings in the second and third quarters of the calendar year, before

PWLB rates rose. Variable rate borrowing and borrowing in the five year area could also be attractive in these quarters if Bank Rate was on a falling trend. A balanced approach was the general Sector recommendation.

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

(3.4) The economy in 2006/07

Shorter-term interest rates – Bank 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 MPC switched from a loosening bias on interest rates to a tightening bias. 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 Q1 2006 GDP figures. These revisions also increased the Q4 2005 and Q1 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 Bank Rate in 2006 evaporated and were replaced by the reverse expectation, ie. 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% in November 2006.

This was then followed by another rate increase in January 2007 to 5.25%, which was a huge shock to both the financial markets and to 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 its decision. These fears were indeed confirmed soon after by news that CPI (Consumer Price Inflation) had jumped to 3% in December, Had the rate gone over 3%, the MPC would have had to write a letter of explanation to the Chancellor. The annual growth rate also hit 3%, the highest in two years, in Q4 2006 adding to confirmation that the recent increases in Bank Rate had done little to dampen the economy, and stoking expectations that Bank Rate would have to rise even further.

Longer-term interest rates – The PWLB 45-50 year rate started the year at 4.20% (25-30 year at 4.3%) and fell to a low of 4.05% several times in late September to early November (25-30 year low was 4.2% in September and November). The high point for 45-50 year was 4.5% 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 Q4 2006 and Q1 2007 was underpinned by the rise in inflation expectations.

(3.5) Borrowing and investment rates in 2006/07

12-month bid rates: During early April, the 12 month LIBID rate hit a low of 4.63%. It then climbed steadily towards 5% until Bank Rate was increased to 4.75% on 3 August, when it rose nearly another 20 basis points. Growing expectations of the imminence of another Bank Rate increase saw the rate continue to climb, to hit 5.4% when expectations were realised on 9 November, and Bank Rate rose to 5%. This rising trend continued, and the surprise Bank Rate increase on 11 January saw the 12 month LIBID jump nearly another 20 basis points to 5.76%. It then ended the year at 5.81%.

Longer-term interest rates – The PWLB 45-50 year rate started the year at 4.2% and then rose to 4.45% around the end of Q2. It then fell back to a year low of 4.05% on a number of occasions in late September to early November. However, it then climbed back again to 4.45 % on number of occasions in late January to March, and finished the year on a year high of 4.5%. The 25-30 year rate started the year at 4.3% and hit a low of 4.2% in September and November, before reaching a high at the year end of 4.65%.

(3.6) The Borrowing outturn for 2006/07

The Council undertook new borrowing of £4m during 2006/07 as detailed in Appendix 1. This was predominantly borrowing in advance of need for 2007/08, due to the availability of extremely favourable rates. In addition, two outstanding loans of £1m each were rescheduled in accordance with advice from Sector Treasury Services. The approach adopted during the year was to draw longer term fixed rate debt to both take advantage of low long term rates, and to reduce exposure to fluctuations in short term rates.

A small amount of temporary borrowing was undertaken early in the financial year for Cashflow purposes.

(3.7) 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.

(3.8) Investment outturn and activity for 2006/07

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 its 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 if appropriate. Investments would 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 was forecasting base rate to be on a falling trend from 4.5% to reach 4% in Q4 of 2006, but then to rise again to end Q1 2007 at 4.25%. The Council would therefore seek to make investments with maturity dates during Q1 of 2007, when the interest cycle was expected to turn up, enabling it to lock into higher yielding investments with the maturing deposits.

The Council would use 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 4.6% as an attractive "trigger" rate for 1 year lending, and 4.75% for 2-3 year lending. These trigger rates would be kept under review with Sector Treasury Services.

A core balance of around £3 million was brought into 2006/07. As described earlier in this report the Council undertook borrowing during 2006/07 at advantageous rates in readiness for financing the 2007/08 capital programme, and 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 2006/07, resulted in a total of £8.5m in fixed term investments at 31 March 2007. Advice in respect of rates and terms was taken from Sector, and rates of up to 5.835% were achieved.

The remainder of the investment activity for 2006/07 was cashflow derived and business reserve accounts and short dated deposits where used throughout the year.

A summary of the Councils investments during 2006/07 can be found at Appendix 1 and show that the actual average interest rate received by the Council was 5.51% which compares favourably to both the 7 Day LIBID benchmark rate of 4.84% and the 3 month LIBID rate of 4.99%.

(3.9) Debt Rescheduling

Before the start of 2006/07, it was originally forecast that rescheduling opportunities would present themselves during the year to move out of long term fixed rate PWLB rate debt once rates rose to around 4.5%, whilst Bank Rate was expected to be on a falling trend to reach 4% by the end of 2006. There were several periods during the year when long term PWLB rates rose to 4.45%, especially during Q2 of 2006 and Q1 of 2007, and the forecast rate of 4.5% was reached in March 2007. On the other hand, the expectation that variable rates would fall late in the year as Bank Rate fell, so making restructuring into variable rate short term debt an attractive option, was negated by the major reversal of inflation and growth expectations in Q2 of 2006. This therefore made switching into variable or short term or short term debt unattractive throughout the year.

In accordance with advice from Sector, two loans of £1m were rescheduled during 2006/07. On each occasion a move into very long dated investments was advised in order to take advantage of very low rates. On one occasion a discount of £28,000 was also generated.

(3.10) Large Scale Voluntary Transfer (LSVT)

A possible future LSVT raises complex and critical decisions, which will need to be considered in advance of the transaction taking place. The Council will continue with a longer term portfolio strategy, in order to ensure that the Authority is not exposed if the LSVT fails at the ballot.

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.